Indian Economy: Some Contemporary Perspectives
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Lecture 21
Indian Economy-Financial Sector 3

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So, hi everyone, we are back to our course Indian Economy some contemporary perspectives. Now we are in the twenty first lecture of this particular course and we were discussing the banking sector reforms. And in the banking sector reforms, we mostly focused on how we can go for revival of the banking sector. So earlier it was just on the capacity expansions, we had focused on how we can we can go through those expansion processes.

Whatever were the objective of the government, how government undertook measures to target those economy plus socio economy objectives. And because of that we had to go for two phases of nationalization of banks. And then we focused in the post 90, 91 eras where we had to go for two stages of economy banking sector reforms. And it was Narasimham committee 1 and Narasimham committee 2.

And we are discussing in detail that what all changes banking sector had to incorporate and how they had to go through a structural change in the sense that the banking sector had to adopted new changes in their functioning plus also they had to diversify their activities and government was also quite supportive in that direction. And that why, then we had the era in which we had the non-banking financial companies.

Then we had the developmental franchise institutions. How these institutions played important role in the beginning years in the formative year when we had gone for this second fiber plan industrial revolution. And that industrial expansion was supported by the DFIs but post 91 we found that these DFIs had lot of inefficiency issues in terms of higher NPAs and losses incur duty protective environment.

So, post 1991 some of the DIFs were converted into commercial banks and commercial banks and as per the Narasimham committee report they were given opportunities for diversification and also engage in certain activities. So most of the DFIs are almost now as a commercial bank. So commercial banking arm was given to them. Then we also focused on how we had to open the space for the private sector.

So, the government had a complete signal that there is no intension to go for phase of nationalization of banks. So that is why the private sector banks were given importance and license is were issued by the RBI, RBI became the solo regulator as compare to the dual regulator system under that we had to, we had a particular division of ministry of finance some had regulating banks plus RBI.

So, we had to go for the unified regulatory structure and under that we had to give more power to an RBI to manage the banking system in the country. And then we had also seen that we had to go for the interest rate deregulation process wherein we had gone for rationalization of cashes of ratio, a statuary liquid ratio, SLR ratios, bank rate and even we also had to go through regulatory set up that would give us some idea about how we had to align our banking system with international standards.

So, Basel 1, Basel 2 how these two regulatory frames work helps our banking system to revive in the modern era to face the global comparativeness the government also allowed foreign banks and the foreign banks are also found it quite difficult because in the regulatory space. The nationalize banks were more given power and they had the more market share but there are no discriminatory regulatory norms devise for separately for the public and private banks.

So, all the banks are supposed to be, supposed we follow the RBI guidelines and that is why the inner banking system thrived and then there was a at one point of time there was regulatory issue of comparativeness and then also the efficiency, inefficiency the banking structure was also mode by the inefficiencies with regard to the non-performing assets because of the privately sector landing unless recovery.

So that lead to over a period of time accumulation of NPAs though the banking sectors size will be increasing expanding every year. So, the ratio was not high but in terms of actual number it had gone up. So, it during 99 before 1990 or 1980s we had the NPAs of less than 300 crores but then after that it became more than 500 and subsequently we experience a severe damage to the banking system in 2016 when we had to go for the structural changes again.

In this particular lecture we will be focusing on the recent developments also and plus some changes that are linked partially to the banking sector plus all should be finance sectors. So, we will be seeing now the contemporary development. So, we will now be moving to focus on certain committees reports we will be also referring to economic surveys 2016-17.

And then we will be moving to, we will be moving gradually to the frame work which we are living in the banking regulations that we are facing so in term recent developments we will be targeting that.

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So, this is what so for this particular lecture I have referred this very good document that I found about Mohan Dasi referred in the last lecture also, then Sury, Goyal remain same, Padmanabhan S. G article is really good on the capital account convertibility central bank speeches it is of on BIS then I found Patnaik and Shah reforming India’s financial system. It is also some kind of walking paper but this also gives a lot of ideas.

But where it is linked I will tell you in the later sessions and may be in the coming after 5 to 10 minutes.

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The objective is same to focus on the non-banking segments and regulations of the India's banking sector. Financial sector regulations and recent developments.

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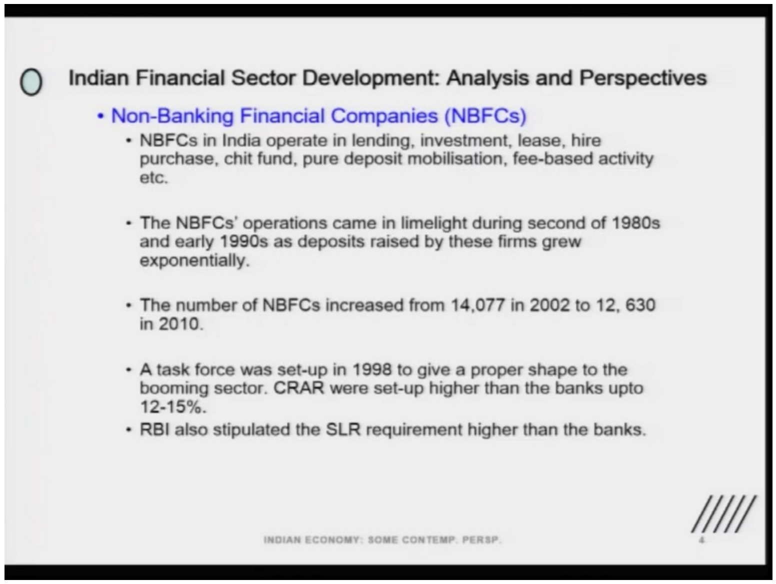

So, in India NBFCs where therefore very long time so if you remember we were discussing about financially intermediaries at the time of independence. So, these were the money lenders and different form of aggregators they were extending loans to the farmers and other appearance classes but in 1990s this was given an extraordinary importance and it also led to the NBFC revolution in India.

So, a task force was set up in India in 1998 to give a proper shape to the booming sector and then at that time this particular sector reached to an extent that it became quite popular not only in the urban set up but in the semi urban and the rural segment also. So, during 1990s I would say late 1990s there was whole lot of boost to the NBFC sector.

And there was a mushrooming across the country in terms of opening up the new NBFCs lot of NBFS became popular for their size and in terms of the reward and the random free trans they were promising to the investors. But after that it had a negative impact on the economy because after 4 to 5 years in the beginning of 2000 most of the NBFC disappeared and there was a consultation of the NBFC industries only the large shareholders they survived.

And RBI also had to come up to regulate the NBFCs because they had to designed certain frame work so that they should not be any spill over on the banking sector. So, RBI had set up SLR requirement higher than the banks just to make sure that it does not lead to spill over or systemic risk, the spill over to banking sector. The number of NBFCs also increase 14000 to 12630 by 2010.

And you must have read in newspaper in September 2018 how NBFC crises lead to the whole lot of debate and discussion on the survival of this particular sector. And also, on the regulation of this particular sector. So, this particular topic will be discussing in later may be in the next session or next to next session. So, for the time being we can say that the liberalization of the banking sector even the licensing given to the private sector this also led to the development of the NBFC sector, NBFC provided a lot of a liquidity to the financial system.

It also had penetration to the semi and the rural segments. And that is why this NBFC now a days it had become systemically important in situations. Some of the NBFCs are now equivalent to the commercial banks and even have the size of the smaller public sectors banks. Now with this background I think this is sufficient as if now to talk about the NBFCs.

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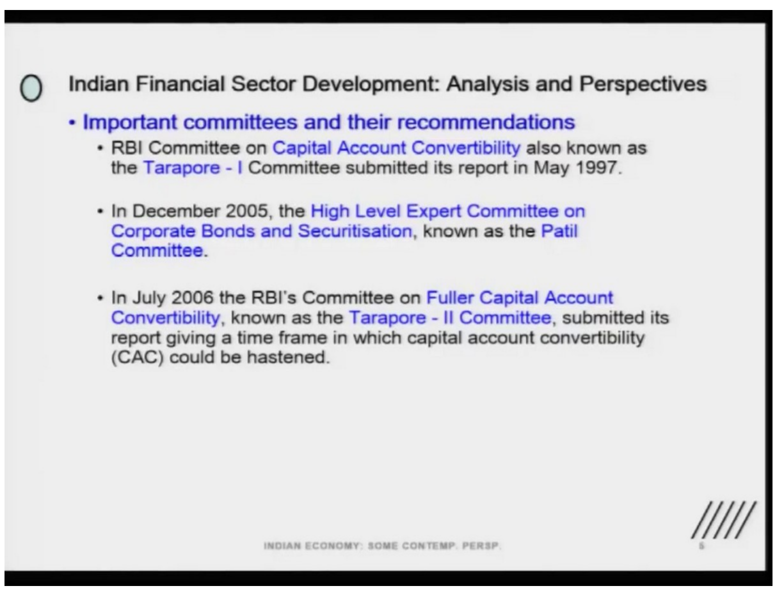

Now in later years, in we are now into the 2000 and 2010 so may be the you can say before 2005 and after 2005. After 2005 we had a lot of developments there was one recommendation by the Tarapore committee towards about the capital account convertibility because it was found that. So, in the economy was opening up we were having an expanded financial sector and at that point of time there was lot of debate and discussion that whether we should be having a complete convertibility rupee not only on current account but also on the capital account.

Now capital account becomes quite controversial topic because it consists of the inflow and outflow of our capital which means that the foreign institutional investors, foreign portfolio investors will also be allowed. And the entirety which are holding their wealth in terms of national currency they we will be allowed to covert in any form of currency. There are advantages and disadvantages of capital account convertibility one advantage is that their transaction is smoothing takes place.

And because of that this may have a positive spill over on the trade but another point of view is that the domestic currency becomes weak. And it may happen that it may not be relevant for the transaction because the popular currency may dominate over the domestic currency. And since the volume of transaction in rupee was really low. So just to make sure that rupee remains significant or it should have some contributions.

So capital convertibility was not recommended by the Tarapore committee. It was report were submitted in 1997 and this committee had recommended at until and unless India has a very strong macroeconomic fundamentals in terms of fiscal deficit, in terms of current account deficits, in terms of external commercial borrowings, in terms of the domestic inflation and all other parameters.

Then only it should go for capital account convertibility otherwise it may have a speculative attack on the domestic currency and may not and domestic currency may not be relevant. In December 2005 high level committee on corporate bonds and securitization was, so in India unfortunately corporate bonds market is not well developed and unlike government bond market where we have a certain limitation on investments.

So public sector banks and the insurance companies pension funds are encouraged to invest to buy the government securities open market operations are quite high liquidity but unfortunately in India corporate bond market was not developed. And that why there was a committee set up in 2005 to look after whether the scope for having a separate channel for the corporate bond market. So that the companies will not only rely on the capital market or the stock market for borrowing they can also borrow through the bond market.

And this committee had come up with lot of recommendations going through from not only from the liquidity side but also from the regulatory side. The report is available on the RBI website and it is quite insightful so if you want you can refer. In 2006 again since the full capital account convertibility issue was not completely settled the Tara pore committee too had to give recommendations and give recommendation in 2006.

So capital account convertibility then in 2006 it was recommended that since the rupee is not one of highly liquid currencies in the world. And the macroeconomic fundamentals are not quite low burst. And under an if RBI act though there is a limit on the fiscal website but government was not able to meet there is also requirement that until unless those requirements are met then only there will be full capital account convertibility.

But post the committee had also recommended some phases that in not only in one phase but all in three phases capital account convertibility should take place. And now there are some relaxations with regards to the nonresidential Indians investing in capital market with regard to some qualified investors. So, there are some relaxations but it is not fully convertibility as we see in the case of some other countries.

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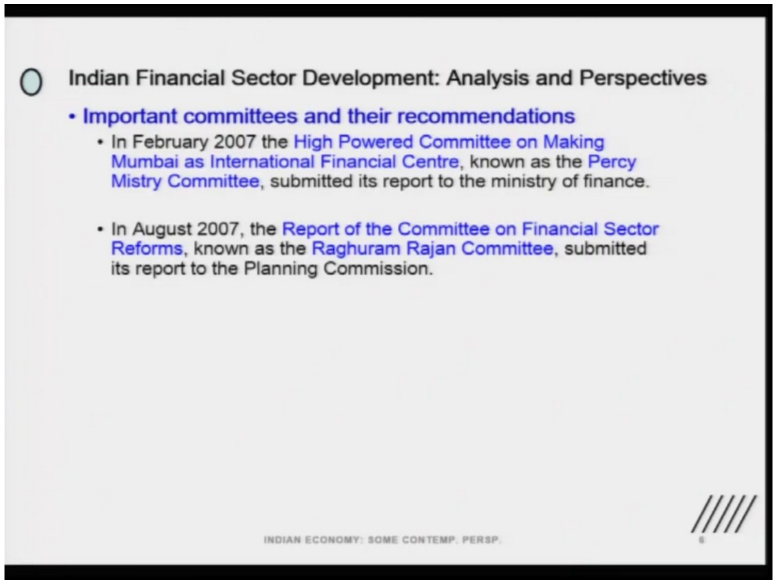

Then February 2007 there was a high-powered committee also of making Mumbai as international financial center and this was, this is also known as the Percy Mistry committee. And it also summited the report and this particular committee had interested the task to recommend or to make recommendation and these recommendations should be in a futuristic manner. So that in a more sustainable way Mumbai can become one of the global financial centers.

And it can also attract the amount of investment as compare to what we see in case of bricks in other countries. Then in 2007 planning commission had set up very commendable committee that give recommendation on every aspect of the financial sector reforms. And it was called the Raghuram Rajan committee report. And it was submitted with the planning commission it is also called as Gen next reforms in the case of financial sector.

And this committee had recommendations touching each and every area even the area of financial inclusion. So, in case of financial inclusion also this particular committee is well known.

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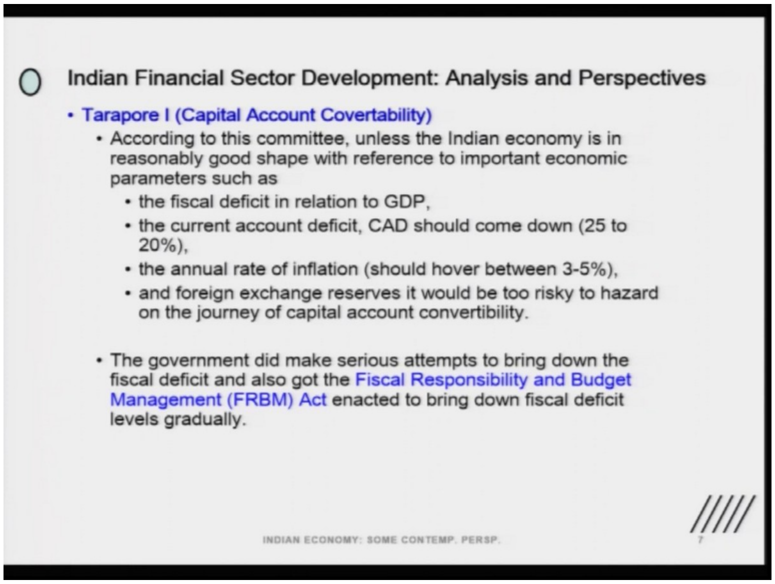

So Tarapore 1 committee at that time I have already discussed that there were some recommendations linked to the macroeconomic fundamentals of the Tarapore 1 committee. And this committee said that until and unless the inflation, the current account deficit, fiscal deficit targets are not made it is not advisable to go for a capital account convertibility. And at that time India was not in that comfortable zone in terms of forex reserves.

So, our forex reserves were not as high as we have right now. So, at that time some apprehensions about the speculative attack on the Indian exchange rate and also in terms of going for high conversion of and there are also apprehensions that there would be high conversion of domestic assets into foreign assets may not come in the expected manner. So that is why this particular committee recommendation was on hold for the capital account convertibility.

Then Indian government had also gone for enactment of fiscal responsibility and budgetary management act. And this act also had put a very estrangement norm on the fiscal deficit right now it is 3 percent at that time it was 3-point percent.

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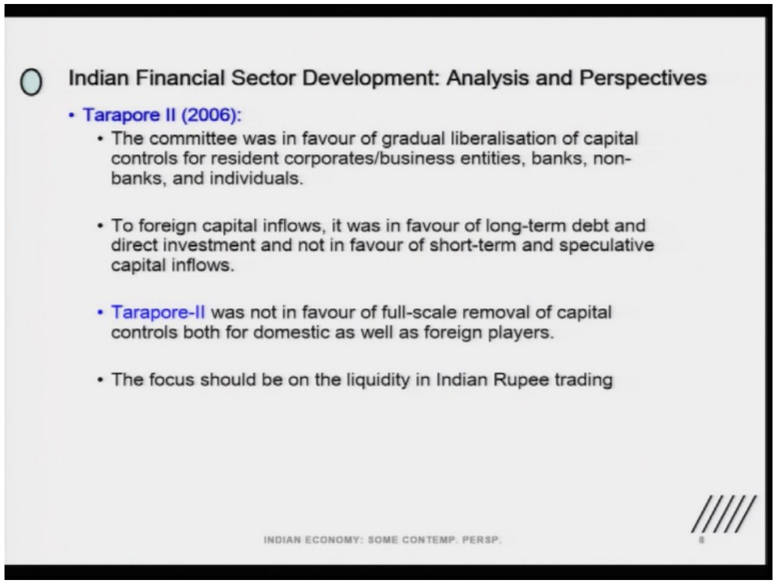

Tarapore 2 committee recommendations where quite useful but this as I told that this committee had to go for a recommending a structural change in the sphere capital account convertibility external commercial borrowings were put on check. They were also allowed to a certain extent the investments were also encouraged in a different form not from the foreign portfolio investors or foreign qualified investors.

If the foreign qualified investors registered with the SEBI and if they follow each and every disclosure norm then they were also allowed but it happened in a phase wise manner it then happened but still we are not fully convertible. Capital account convertibility is still a concerned. And at that point of time one may concerned was that in international currency market rupee is not one of the frequent reading, frequently traded currency.

So, at that time skipping in mind the low liquating in the Indian rupee it was recommended that we should not go for the full account convertibility otherwise whatever forex reserves that we have, we may have to spend the whole for just to manage the manage floating system that we have. So central bank will have to put extra efforts and may not be able to manage the domestic indicators so that is why it was recommended that it should have in a phase wise manner that will be in three phases 2006 and 2009 post 2000 and after post 2009 and after that.

So, this committee also did not give full scale recommendations but there are certain limitations, certain recommendations were made in favor of the banks, in favor of the forms so that they can extent expand there being these activities they can have some amount of borrowing and lending and not only rupee but in some other currencies just to make sure that this does not hinder the development process that. So, expansion of the banks and the forms were given an opportunity.

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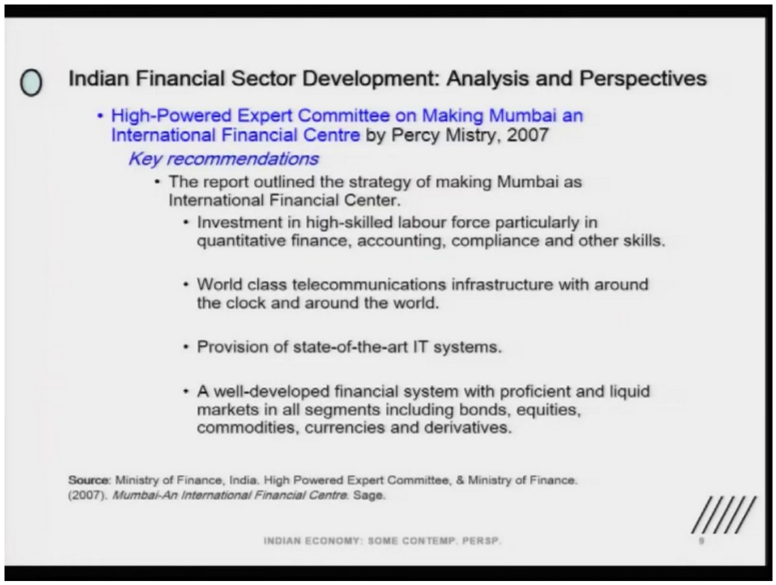

Then, high powered expert committee on making Mumbai an international financial center. It was Percy Mistry committee 2007 and it has gone for the overall recommendations even finance minister have that time we had P Chidambaram. So, at that time he had gone for an appreciation of this particular report but there was also a certain regulation with regard to a capital account convertibility.

So that became one of the debated topics but still it was recommended that since to make Mumbai as an international financial center you require a high skilled labor forced in the quantity finance plus coding plus other skills. So, it was required that there should be special focus on the man power how are going to be specialize in finance and these people will be called as front office workers.

And there will be sub ordinates and there will be one more linked or para financial accountants and there will be also some kind of law or compliance related course should give more promotions. So that we will have sufficient capital to generate or to regulate or to operate not only the financial sector but also in terms of product innovation. Because financial sector is a quite diversified sector and quite innovative also.

So, we can go for instead of following the global standard of having only contractual or non-contractual kind of products. We can also have our one I would priority products not only in terms of quality finance financial modeling but also in terms of accounting and other standards. So, this was required there was also since most of the ITEA services IT enabled services going to be having a headquarter or may be a back-office services available in India.

So, there should be a focus on higher connectivity. And it was also recommended that there will be a worldwide, world class telecommunication infrastructure set up. So that there would be access of information around the clock and there should not be any kind of hindrance with regard to the technology. There is also recommendation to set up state of the at IT system to supplement this telecommunication sector.

There was also recommendation to have a highly liquid all segments of the financial sectors which comprise equity bond then derivatives and all other types of standard and substandard contracts commodities for it's all types of financial instruments financial product should be available. And it should be quite diversified with the outreach of the even not only the Mumbai but outside Mumbai's masses.

So, this why the first office kind committee recommendation so I thought I should be mentioning here. So that you should be aware of that government has already set up first type of committees to look after. So here we have the ministry finance, high powered expert committee. It is the Mumbai and an international finance center you can have a look it is of level on the ministry of finance website.

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Then we had a GenNext reform it is also called as a hundred small steps. So, based on the request of prime minister Manmohan Singh, Raghuram Rajan had agreed to walk on the financial sector reforms. And in 2007 he had given gigantic process to help understand the GenNext reforms. And this reform had given a lot of hope to the financial sector. Because for the first time our committee had gone for such elaborate recommendations on each and every component.

Some of the recommendation I have added but for your reference you can just have a look on this he document is available at Ahmedabad website. And you can access it there and it has the whole lot of recommendations for the first time this committee recommended that RBI should have the single objective of just targeting the inflation. And you should target either on a single rate or in a band so 4 plus minus 2 that we have.

And if it has a target then it can target in the medium term. The repo and reverse repo should be the main target for the or it should be the policy rate, the target rate the policy rate. And it should be in the hand of RBI based on the movement of inflation and the exchange rate management system they can decide about. They opening up the corporate and government bonds for foreign investors in rupees.

So just to promote the rupee and so here you have the bonds are traded into denominations. It depends, so it can be traded in some other denominations also. But popularly your one is for local currency you need and one is for US dollar. So, in case of local currency you need, so it was recommended that once we start selling the bonds to foreign investors in terms of rupee then rupee will have high liquidity and this will again will have this will also be will become popular after some point of time.

Broadening the base of financial access, financial inclusion should be promoted by means of expanding access to financial services. Such as payments we had saving products, insurance products, inflation protected pension funds. Entry to private forms were also encouraged even the alternative investments were encouraged by some way the committee had recommended some alternative investments or some filter-based investments it adds ease.

For example, financial re a law or it is a called Islamic finance can also come into and this committee had given the recommendation that whatever form of a financing we have even in terms of committee financing system. And if it is not very exploitative then it should be promoted and it should come under the gambit of the regulatory frame work.

And they should be registered and they should follow the norms of disclosures in terms of not only going for declaring the bad assets but also in terms of they should also be put into context of high capital education norms. So, these were the major recommendation in terms of financial inclusion for the first time the committee had given recommendation that we should target un banked population and we should extend the financial services to those populations.

And this would be in the form of saving products, insurance product, and inflation product repression funds.

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It was also for the first time I was recommended that government should go for if the banks are making losses then government should go for selling those loss-making banks to other pre-issues or the strategic investor but the one line of caution that if it is a large bank. And if it is a largest bank which is making losses then we cannot sell it to the other public sector bank because this will create shock and this shock is spill over may have very negative impact.

So, it was decided we should go for some kind of right issue. This right issue may create some kind of positive buzzed on the balance sheet of the form. Now it was all on also recommended that both should be set up for the public sector bank. So that stronger boards may be recommended for the public sector bank. So that they will have a well-diversified board member. And they will also have the members outsides and shareholders will also be given free banks or bank should be allowed to set up ATM a branch anywhere.

And a SEBI will be this whole authority to regulate the trading regulation. So, this was the recommendation. So overall what we have covered so far is that we talked about the NBFCs and then we talked about the certain reforms major. And then we are we discussed also the Raghuram Rajan committee and this committee had lot to recommend for the Indian financial system. After the this we will have some more committees to discuss. Thank you, thank you so much.