Chapter 2: Pre reforms Indian Economy and financial reforms

The Indian economic system before 1991 has been aptly termed as classic financial repression by various scholars (Mohan (2005), Verma (1998)). The monetary system, the financial system and the exchange rate system were made to serve government’s plan priorities rather than the public as a whole. As Reddy (2002) puts it, it was a balance sheet jointly for the government, the RBI and commercial banks where in transactions were happening not on economic reasons but on plan priorities of the government. Since the economy was relatively closed, there was large scale pre-emption of financial resources for financing the fiscal deficit (Mohan 2005). For example, the RBI used regulatory reserve mechanisms like Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) to finance the fiscal deficit. If deficit was not met through these resources then there was a provision for automatic monetization. The government’s debt market was also suitably modified for this purpose, government bonds were issued at low rates (Ahluwalia (2001)) with commercial banks statutorily made to purchase these bonds. For all practical purposes the debt market was dead (Verma (1998)).

2.1 Pre-reform financial system

The commercial banking system was characterized by an administered interest rate regime with the government setting the interest rates both for lending as well as for deposits. Additionally, the government employed a credit rationing policy favoring certain “priority” sectors with loans at subsidized interest rates while other industries had to pay very high rates thus resulting in cross-subsidization (Reddy (2002)). The MRTP Act (Monopolies and Restricted Trade practices Act) controlled the private investment and its scale of operation.
The securities market was heavily regulated through the Capital Control Act, which gave the government, the authority to determine who can raise money, how much they can raise and through what instruments. The control was so extreme that the government even prescribed the debt-equity ratios for industries and the technology to be used to conduct their operations. Additionally, the institutional framework for the capital markets was very weak- with no regulator for the capital markets, no clearing system and no technological platform to conduct operation. Capital markets were also not open for foreign investors.

The exchange market reflected the closed nature of the economy with a single currency fixed exchange rate system. Only RBI had the authority to conduct foreign exchange transactions with no other intermediary in the foreign market. There were severe limitations on currency exchange transactions which including disclosure of the purpose for which foreign currency was required and there were also quantum restrictions depending on the purpose for which foreign currency was needed. The RBI had a system of issuing licenses for exchange transactions.

2.2 Need for reforms in 1991

The immediate need for reforms was a balance of payment crisis in 1991. Due to fiscal profligacy the combined fiscal deficit was 9.4% of the GDP in 1990. The breakup of the Soviet Union dried up the long term rupee debt, the crisis in the Gulf pushed up oil prices and India had long-term contracts with Iraq and all of them had to be renegotiated at higher prices. The remittance from Indian workers in the Gulf countries had completely stopped. Coupled with these external factors, there was political and social instability at the center. This confluence of factors raised the prospect of rating downgrade for India’s sovereign debt with a significant possibility that the country would default on its external commitments. Prominent economists at
that time urged that the only way out were to address the problems through structural changes in the economy. The overall goal of the government, according to the Ministry of Finance, was to make the financial system more competitive with a wide choice of instruments accessible to the participants through the development of new markets. This was required for the promotion of competition and breaking up of state owned monopolies. The sound regulatory framework is required not only for the promotion of competition but also for safeguarding the interest of investors. The specific reforms are discussed in the following paragraphs.

2.3 Financial sector reforms

2.3.1 Banking sector

The reserve requirements were lowered to statutory minimum levels so that more funds would be available for banks to lend. Prudential norms were introduced in 1992. Entry norm was eased for private sector banks and foreign banks in 1993 so that the competition would increase in the banking sector. The most important reform the government undertook was a gradual deregulation of interest rates which started in 1994. Interest rates were deregulated for lending as well as for deposits except for short term maturities by 2005. For the classification of assets, income recognition and provisioning of bad debts to increase the capabilities of risk management (Mohan (2005)). Capital requirements were raised to Basel levels (9% in the case of India). Government banks were allowed to access capital market for diversification of capital base and to tune government banks for market discipline but government ownership was retained. Greater autonomy was given to banks in their lending decisions (both volume and terms of lending) subject to macro regulation of the RBI (Reddy (2002)). The most important reform for the management of bad assets was the enactment of the SARFAESI Act in 2002, which contained, among other things, provisions for securitization of assets.
In the case of monetary policy, statutory liquidity ratio and cash reserve ratio were brought down to statutory minimum levels thus releasing huge amount of money for banks to lend. Automatic monetization was done away thus it became no compulsion on banks to invest their money in government securities. To manage short term liquidity in the financial system the RBI introduced Liquidity Adjustment Facility (LAF) in 1999.

2.3.2 Security market reforms

In the government security markets, bond rate were deregulated and price discovery was instituted through auctioning. Primary dealers were allowed to operate in G-security markets and even foreign investors were allowed to operate in debt markets subject to some restrictions. In case of stock markets, the Capital Control Act was abolished and capital issue regulations were greatly eased. Now firms can issue capital without the intervention of the government. A new regulator for capital markets the Securities Exchange Board of India (SEBI) was given a statutory status in 1992. SEBI has in turn introduced prudential regulations for brokers and other intermediaries. Indian capital markets were opened up to foreign investors and foreign portfolio investment was allowed starting in 1993. Foreign direct investment norms were also eased so that foreign companies can invest up 100% in most of the industries barring a few. Technology wise, dematerialization (electronic bookkeeping) of stocks was made compulsory and online trading was introduced in all the stock markets. Strict regulations were instituted for insider trading.

2.3.3 Exchange market reforms
The single currency fixed rate regime was abolished in 1993 and a new system of managed float was introduced. Full current account convertibility was allowed in 1994 and the capital account was made partially convertible (for foreign institutional investors and non-resident Indians full capital account convertibility has been provided). Domestic firms were allowed to tap foreign capital market through the issue of American depository receipts, global depository receipts and foreign currency commercial borrowings. Though ECB (External Commercial Borrowings) channel was liberalized, some restrictions are still there with respect to maturity and the total amount. Indian companies were also allowed to invest in foreign ventures. The dominant position of RBI with regard to foreign exchange transactions in the earlier regime was changed with the more liberalized regime consisting of many players like commercial banks in the exchange market. Indian domestic residents are now allowed to open foreign currency accounts with a maximum limit of $25000 per year.