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ECONOMIC REFORMS OF 1991-AN ANALYSIS OF POLICIES AND PERFORMANCE OF INDIAN FINANCIAL SECTOR

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ABSTRACT

In the light of growing global integration, the New Economic Policy was launched by government of India in 1991 to bring Indian economy at par with world economy. As a part to this new policy, various reforms were introduced in different sectors of Indian economy to make them efficient, competitive and productive. One such important sector where reforms were given focus was Indian financial sector. India has had more than two decades of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. This paper is an attempt to make a complete analysis of various policy reforms undertaken in financial sector and a critical appraisal of the performance of various financial segments of India under those reforms. It is observed that the approach being adopted for financial sector reforms is that of 'gradualism'. These reforms have been very successful in improving the health and competitiveness of Indian financial sector. Banking industry has emerged from loss making to profitable industry. Foreign market reforms have unable Indian economy to go global easily. Interaction with global economies since reform's introduction has grown rapidly. Now we can see FIIs flowing into India for various purposes significantly. Government debt market, NBFCs, IRDA, SEBI and many more improvements have shown up in past two decades of reforms. On a whole the results have been in favor to make Indian economy competitive and healthy to stand in world.

KEYWORDS: Banking, Economic Reforms 1991, Financial sector, FOREX, Government Debt Market.

I. INTRODUCTION

India has had more than two decades of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. After independence Indian economy adopted a path of planned economic development and for fulfilling this strategy it has adopted conservative policies. Public sector was always given priority and was considered as the most important catalyst for growth. The policies were framed in a manner to mobilize resources from private sector and channelize them towards public sector to promote development programs and investment in infrastructure projects. Monetary policies were formulated keeping in mind the needs of financial flows for industrial sector and for controlling inflation. Similarly foreign trade policies were aimed to secure and protect domestic industry against foreign industries. All these conservative policies continued for long and it was later on found in 1991 the need to introduced drastic reforms in Indian economy. Prior to 1990s, the situation of Indian economy can be summarized as follow:

- Indian financial sector was a classic example of 'financial repression'. The sector was characterized by:-
  a) Administered interest rates
  b) Large scale pre-emption of recourses
  c) Extensive micro regulation which were directing the major portion of the flow of funds to and from financial intermediaries.
- The working of the financial intermediaries, most of them being public sector enterprises, was marked by lack of transparency in working and limited disclosure.
- Level of transparency in securities market was also very low.
- The fixed income securities segment was dominated by government securities whose interest rates were decided through administered fiat. So there was no free functioning of financial markets to determine rates of interest.
- Compartmentalization of activities and entry barriers also eliminated the scope of competition among existing financial intermediaries, leading to low levels of competition, efficiency and productivity in financial sector.
- Financial intermediaries' levels of capitalization were low.
- Lack of commercial considerations in credit planning and weak recovery culture resulted in huge non- performing loans.
- Financial intermediaries were required to invest huge funds mobilized by them in government securities to meet so called norms of SLR, CRR etc. that leads to pre-emption of huge resources from intermediaries to finance government's high borrowings.
- Interest rate on government debt was administered and the rate which RBI charged from government was concessional.
- Also, India was a closed economy, having very external capital flows.
- Debt markets were underdeveloped and there was no secondary market for government securities.
- The level of automatic monetization of fiscal deficit was high during the major part of 1980s.

However despite of many flaws, the nationalization and social control of financial intermediaries do resulted into sharp increase in rural branches of banks, increase in deposits and savings. There was increase in credit flow towards economically important but neglected activities like agriculture and small scale industries. On the whole there was no major failure of financial intermediaries in this period.

But, as the world economies were undergoing growing integration during that period, Indian economy felt the need to undergo economic reforms so as to strengthen the India's position at international level. Accordingly, economic reforms were initiated in 1991 covering reforms in four major sectors of Indian economy –industrial, financial, external and taxation.

This paper is an attempt to study and analyze the financial sector reforms of India since 1991. The path for Indian economy towards financial sector reforms has been very disciplined, gradual, cautious, measured and a steady process.

II. LITERATURE REVIEW

Kumar (2002), in his paper analyzed that economic reforms have changed the Indian financial sector completely. New banks have been allowed to get opened by Reserve bank of India on the recommendation of Narashiman committee in private sector. Initially Indian banking system was dominated by public sector bank but now the situation has been changed. New banks have gained a reasonable position in banking industry by using sophisticated technology and professional management. The main objective of the paper was to make an assessment of Indian private sector banks.

Chakrabarti (2004) analyzed that financial sector in totality and particularly banks still suffer from non performing assets problems though the situation has improved as compared to past. The new developments like the SARFAESI Act have provided new opportunities to bank to recover those nonperforming assets. Over time, the Indian banking industry has become more competitive and efficient.

Ben Naceura and Mohammed omran (1989) ,in this paper an effort has been made to examine the impact of bank regulations, concentration and various institutional and financial developments on profitability and bank margins across a broad selection of Middle East and North Africa countries. The period of study has covered from 1989 to 2005. The results of the study revealed that bank capitalization and credit risk characteristics have a positive and significant impact on bank's efficiency and profitability. As far as the impact of macroeconomic and financial development indicators is concerned ,they concluded that these variables have no significant effect on net interest margins except for inflation.

Kalian (1989) in his study made attempt to gather first of all the major policies and reforms concerning the banking sector of our country. Later the paper analyzed the impact of such policies and reforms upon the banking sector. A positive change was observed in the area of improving the role of market forces, regulation norms, introduction of CAMELS rating system, lowering of NPAs and improvement of technology. However, the results also revealed the failure to bring up a banking system which is at the competitive level with international standards. Financial sector has been mainly controlled by the government as public sector banks being the leader in all the areas of banking sector industry.

III. OBJECTIVE OF STUDY

The objectives of this study can be summarized as given below:-

- To determine what all reforms were undertaken in Indian financial sector
- To make an analysis of impact of policies and performance under financial reforms undertaken.

IV. FINANCIAL SECTOR REFORMS-THE STRATEGY ADOPTED BY INDIA

Financial sector over last two decades has been transformed into a reasonably sophisticated, diverse and resilient system. This kind of a system has been the result of well sequenced, elaborative and coordinated policy measures to achieve a system which aimed at making Indian financial sector efficient, competitive and stable. The strategy so adopted can be understood by assessing the sequence so followed by Indian government to attain it:-

- The approach being adopted for financial sector reforms is that of 'gradualism'.
- India has attempted to attain best practice international standards keeping in mind its own capabilities.
- Reforms within the sector and across the sector were designed to reinforce each other.
- During early reforms phase i.e. 'first generation reforms', attempts have been made to create an efficient, productive and profitable financial service industry in an environment of flexibility to operate and functional autonomy.
- In the second phase of reforms, somewhere between 1990s, known as ' second generation reforms', all attempts were directed to strengthen the financial system and introduction of structural improvements.
- In India, the reforms followed a consensus driven pattern of sequenced liberalization across sectors.

V. POLICY REFORMS IN FINANCIAL SECTOR

This section will make an attempt to gather various policy reforms undertaken in different segments of financial sector, namely banking sector, government debt market, forex market and other segments.

A) Reforms In Banking Sector:-

As commercial banks constitute the largest segment of Indian financial system, hence many regulatory and supervisory norms were initiated first for commercial banks and later extended to financial intermediaries. The reforms introduced in banking sector include:-

- ✶ Introduction and sequential implementation of international best practices and norms in areas of capital adequacy requirements, income recognition, accounting etc.
- ✶ For ensuring an efficient and stable banking system, the supervisory system has been revamped by establishment of Board of Financial supervision as apex statutory authority.
- ✶ CAMELS' supervisory rating system has been introduced.
- ✶ Redefining the role of statutory auditors, increased internal control through improved internal audit.
- ✶ New and strengthen norms of corporate governance and due diligence on significant stakeholders emphasized.
- ✶ Steps were undertaken for recapitalization of banks, firstly from government resources to bring them up to appropriate capitalization standards.
- ✶ In the second phase, increase in capitalization has been done through diversification of ownership to private investors up to a limit of 49%, thereby maintaining ownership and control with the government.
- ✶ With the widening of ownership most of these banks have been publicly listed thereby introducing greater discipline and transparency through enhanced disclosure norms in this sector.
- ✶ Phased introduction of new private sector banks and expansion of foreign bank branches have been focused.
- ✶ Operational autonomy has been granted to public sector banks.
- ✶ There has been sharp reduction in pre-emption requirements through phased reduction of SLR, CRR etc. rates, market determination pricing of government securities has been introduced.
- ✶ Setting up of Lok Adalats, Credit Information Bureau for Information sharing on defaulters as also other borrowers.
- ✶ Setting up of Clearing Corporation of India Limited.
- ✶ Setting up of INFINET for communication purposes in financial sector, Negotiated dealing system for digital trading and RTGS system.

B) Reforms In Foreign Exchange Market:-

The Indian foreign exchange market have been highly regulated and controlled since 1950s. consequently both the current account and capital account were closed and foreign exchanges were made available to RBI through a complex mechanism. In order to introduce openness and flexibility in Indian foreign exchange market the following reform measures were undertaken:-

- ❋ There was a move towards market based exchange rate in 1993 and sequently allowing current account convertibility were the key reform measures.
- ❋ Authorized dealers of foreign exchange have been allowed to carry on a large number of activities such as initiate trading positions, borrow and invest in overseas market subject to certain regulations.
- ❋ Banks have been allowed to undertake foreign exchange operations.
- ❋ FERA has been replaced by FEMA Act, so as to permit greater freedom in markets.
- ❋ Development of rupee foreign currency swap market has been made.

- Entry of new players in the market has been allowed and permission has been given to avail forward cover and to undertake swap transactions subject to normal limitations.
- FIIs and NRIs have been given permission to trade in exchange traded derivative contracts subject to few constraints.

C) Reforms In Government Debt Market:-

Many reforms have been carried out in government securities market. The number of instruments has been increased and institutional measures have been undertaken as follow:-

- System was moved from financial repression to market oriented system.
- Administered interest rate has been overtaken by the system of auction for price discovery for government securities.
- Statutory liquidity ratio has been reduced in phases to the statutory minimum level of 25%.
- Automatic monetization of government's fiscal deficit has been phased out and now government has to borrow from market at market determined interest rates, thereby making government cautious of its expenditure.
- Primary dealers have been introduced as market makers.
- Delivery versus payment settlement system was launched to ensure transparency.
- Repo was introduced as a measure of short term liquidity adjustment.
- Treasury bills for 91 days were introduced for the purpose of liquidity and benchmarking.
- FIIs were allowed to invest in government securities.

D) Reforms In Other Segments Of Financial Sector:-

Some other miscellaneous reform measures adopted by government in 1990s include:-

- Measures have been introduced for non-banking financial companies as well to improve efficiency, competition and productivity.
- Lot of NBFCs has been bought under RBI regulation and other intermediaries have been bought under Board of Financial Supervision.
- IRDA has been established to regulate and supervise the insurance sector.
- SEBI has been introduced as a regulator of equity market to ensure transparency, competition and efficiency in securities market.
- Mutual funds have been opened for private sector in 1992,ending UTI monopoly.
- Indian capital market was also opened for FII in 1992 in all securities including government securities.

E) Reforms in Monetary Policy Framework:-

- The basic objective and focus of reforms in this area has been to reduce the level of market segmentation in financial sector by ensuring an increased level of linkage and coordination among various segments of financial markets.
- Another important step in this area is discontinuation of automatic monetization, therby ensuring stability in Indian economy by an agreement between government and RBI in 1997.

VI. Performance Appraisal of Financial Sector Reforms:-

This section of paper is an attempt to analyze and appraise the result of various policy reforms introduced in different segments of Indian financial sector as a part of New Economic policy of 1991 for reforming Indian economy.

A) Appraisal of Banking Sector Reforms:-

- Key achievement has been sharp improvement in financial health of banks.
- Significant improvement in capital adequacy and asset quality
- Increase in competitiveness and improvement in efficiency of banking sector reflected by decrease in interest spread, operating expenses and cost of intermediation after reforms.

- Technological up gradation and better human resource management.
- There are gains in terms of outreach of bank branches achieved in phase of social banking.
- Despite fall, direct lending to disadvantageous sectors have been high during reform period. Decline in fact reflects greater flexibility provided to banks to meet the target. It they fails, they deposit with apex institution who then passes it on to the targets.
- There has been increase in levels of per capita deposits and credit.
- Banks have maintained consistently high rates of growth in assets and liabilities.
- Despite of reduced SLR banks continued to invest in G- sec, thereby making it a profitable centre for themselves and high fiscal deficit for government.
- Overall capital position of commercial sector banks has witnessed improvement. 91 out of 93 banks maintained CRAR at the rate of 9%.
- Banks have deployed retained earnings from profits.
- Asset quality of banks improved. NPLs ratio of both advances and assets reduced substantially and consistently. This is largely due to improvement in credit appraisal process.
- Recovery performance of public sector banks has been better than private sector banks both old and new.
- Foreign banks exhibit best recovery performance and lowest NPL among all.
- Both interest income and interest expense of banks as proportion to total assets have declined. However expenses reduced faster than income.
- There has been general reduction in operating expenses.
- Reduction in interest spread has been across banks, however it is the highest for foreign bank and lowest for private banks.
- In total income and assets of the banking system, share of public sector reduced, private sector especially new private sector increased considerably and foreign banks share also reduced due to focus on off balance sheet items. Still public sector dominates.
- From the position of net loss in mid 1990s, the public sector banks have been able to generate largest amount of profits.
- There is a general improvement in profitability across bank groups.
- A major impact of reform process on the Indian banking system has been greater diversification of banks into non fund based businesses.

B) Appraisal of government debt market reforms:-

- Government market borrowings were initially low but gradually it increase to substantial.
- Still there has been substantial reduction in yield as well as cost of borrowings.
- G- sec market structure has improved
- Administered interest rates have been withdrawn and replaced by market determined rates thereby making it more competitive.

C) Appraisal of foreign exchange market reforms:-

- Significant deepening of market in terms of instruments and variety of players.
- A survey revealed while forex market turnover declined the world over considerably compared to 1998, it increased in India.
- Full convertibility on current account and extensive liberalization of capital count transactions have facilitated transactions in foreign currency and hedging various risks associated with it.
- RBI intervention has been very minimal showing role of market forces in determination of rupee value externally.
- Inflow from outside has also increased considerably.

→ Foreign exchange reserves in India have reached historical peaks.

D) Appraisal Of Other Segments Reform:-

- Among cooperative banks, there have been improvements in capital position, reduction in spread and operating expenses.
- Capital adequacy of DFI's has improved and NPL reduced.
- A large number of NBGC's have discontinued their public deposit taking activities.
- In insurance sector also, a large number of private company generally with foreign participation have entered.
- Equity market showed growth in terms of resource mobilization, number of stock exchanges, trading volumes etc. significant improvements in efficiency, transparency and safety due to coming of SEBI.

VII Some Issues in financial sector reforms:-

No doubt a lot of good results have been observed after the initiation of financial sector reforms, still there are certain issues which continued to be a topic of debate in India :-

- There has been considerable debate on privatization of public sector banks.
- There has been debate going on regarding treatment of insolvent banks. Instead of closing there is a proposal to merge such banks with healthy public sector banks. Critics argue it will lead to moral hazard problem as commercial banks are dominant and they hold deposits nearly 70% of small depositors..
- There has been debate on how banking sector is going to help in agriculture sector development and SSI
- Another challenge is effective regulation and supervision including implementation of corporate governance and internal control norms.

VIII. CONCLUSION

With the above analysis of policies and performance of financial sector, it can be clearly observed that these reforms have been very successful in improving the health and competitiveness of Indian financial sector. Banking industry has emerged from loss making to profitable industry. Their efficiency and competitive ability has improved thereby becoming an attractive industry with the passage of time. Foreign market reforms have unable Indian economy to go global easily. Interaction with global economies since reforms on introduction has grown rapidly. Now we can see FIIs flowing into India for various purposes significantly. Government debt market, NBFCs, IRDA, SEBI and many more improvements have shown up in past two decades of reforms. But nothing happens without any debate on it. Though the reforms have done wonders for Indian economy yet critics have come up showing faults from time to time and hence, it can be said that while on one side of coin the reforms have served the purpose, the other side is also not blank and shows some faults in reforms, although the benefit side shines more than the negative in this regard.

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