Y V Reddy: Select aspects of the Indian economy

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Bank of Japan, Tokyo, 27 May 2007.

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Governor Fukui and friends,

I am honoured by the kind invitation of Governor Fukui to visit your esteemed bank. We, in the Reserve Bank of India (RBI), deeply appreciate the gesture. Governor Toshihiko Fukui is highly respected in various central banks' fora for his depth of knowledge, wisdom and very transparent expositions on the economy of Japan and the Bank of Japan's policies. We look forward to Governor Fukui's acceptance of our invitation to him to visit the Reserve Bank and give us the benefit of his address.

At the outset, I would like to recall and record that, in July 1991, the Bank of Japan (BOJ) had provided a credit facility of US$195 million to India against the collateral of gold, which was also fully settled by us during September-November 1991. The timely gesture enabled India to maintain its impeccable reputation of unfailingly discharging its external obligations, and proceed with the program of stabilisation as well as reforms. In fact, that period has been a defining moment in our economic history and separates the pre-reform period from the post-reform period, the latter ushering in an era of high growth and stability.

The BOJ and the RBI have had, in the past, several instances of mutually beneficial and productive interaction. For example, in June 1968, the then Governor of RBI, had requested the Bank of Japan to depute an expert to study the export credit problems in India and suggest improvements in the system. The Japanese consultant, Mr. Yoshiaka Toda of BOJ, identified several gaps and weaknesses in our system, and made several recommendations. In true Japanese tradition, Mr. Toda's final evaluation was that "the Indian export credit system was one of the best conceived by central banks in the world".

Introduction to the RBI

The RBI was established under the Reserve Bank of India Act, 1934 on April 1, 1935 as a private shareholders' bank but since its nationalisation in 1949, is fully owned by the Government of India. The Preamble of the RBI describes the basic functions as "*to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally, to operate the currency and credit system of the country to its advantage*". Thus, unlike the current trend in many countries, there is no explicit mandate for price-stability or formal inflation targeting, but the mandate appears to be similar to that of the Federal Reserve of the USA. The twin objectives of monetary policy in India have evolved over the years as those of maintaining price stability and ensuring adequate flow of credit to facilitate the growth process. The relative emphasis between the twin objectives is modulated as per the prevailing circumstances and is articulated in the policy statements. Consideration of macro-economic and financial stability is also subsumed in the mandate. The RBI is also entrusted with the management of foreign exchange reserves (which include gold holding also), which are reflected in its balance sheet.

While RBI is essentially a monetary authority, its founding statute mandates it to be the manager of public debt of the Government of India and banker to the Government.

The function of regulating and supervising of banks has been assigned to the RBI by a separate legislation enacted in 1949, while the regulation of Non-Banking Finance Companies (NBFCs) has been entrusted to it through an amendment to the RBI Act. The powers for regulation of money markets, government securities market, forex market and gold are derived from the RBI Act and the regulation explicitly entrusted through government notifications under the Securities Contracts (Regulation) Act.

The regulation of current and capital account transactions of the external sector was assigned to the RBI under another statute in 1999, replacing an earlier one in 1973.

In addition to the issuance of currency, the RBI is also entrusted with the responsibilities relating to distribution of coins.

The RBI has been assigned some responsibilities in several statutory bodies such as public sector banks, development finance institutions governing Agriculture, Housing and Deposit Insurance, etc.

The Reserve Bank's affairs are governed by a Central Board of Directors, consisting of fourteen non-executive, independent directors nominated by the Government, in addition to the Governor and up to four Deputy Governors. Besides, one Government official is also nominated on the Board who participates in the Board meetings but can not vote.

The RBI has 22 regional offices, mostly in state capitals. RBI is the debt-manager and banker to State governments (i.e., the provinces constituting the Indian federation).

The RBI renders advise to the Central and the State Governments, particularly in regard to financial sector reforms.

In brief, the RBI has been assigned several functions, in addition to monetary management. In performing each of the functions, the statute as well as the functional content, requires that the RBI exercise varying degrees of autonomy and coordination vis-à-vis the government. The three over-arching features governing the relations with the Government are autonomy in operations; harmony in policies; and coordination in structural transformations.

Glimpses of the Indian economy

With only 2.3 per cent of the world's land area (seventh-largest country), India is the second most populous country in the world with a population of 1.029 billion, which is among the youngest in the world. The proportion of population in the working age group of 15-64 years is currently around 62.9 per cent and is expected to increase to close to 70 per cent by 2026. The "demographic dividend" is expected to extend over the next few decades of this millennium. India is unique in pluralism in terms of languages, religions, ideologies and traditions spread over twenty-eight provinces and seven federally governed union territories, each with its distinct identity and socio-cultural ethos. While the Constitution of India recognises 22 languages as the official languages, the number of mother tongues in India is reported to be as high as 1,652. India is well endowed with natural resources, human resources and varied climatic regions, which is reflected in the institutional architecture: uniquely flexible federalism, democracy with universal adult suffrage, and coexistence of public and private sector.

A recent but positive feature of the Indian economy is the sustained high growth that has been experienced since the 1980s. Real GDP growth, which averaged 5.8 per cent in the 1980s and 1990s, has accelerated to 8.6 per cent in the period 2003-07. In 2006-07 (we measure our financial year from April-March) real GDP growth was 9.2 per cent, which was one of the highest growth rates in the world in that year. If the current GDP growth rate of around 9 per cent is maintained, a person can hope to see the standard of living multiplying by almost five times in his lifetime.

Another noteworthy aspect of the evolution of the Indian economy is the structural transformation that has been underway. At the time of independence from British rule in 1947, we were predominantly an agrarian economy with traditional industrial base, mainly plantation and agro dependent. Today, agriculture constitutes merely 18.5 per cent of GDP, although over 60 per cent of our population continues to depend on agriculture in some form for livelihood. While we regard the performance of agriculture over the past few years as unsatisfactory in terms of our expectations in view of the stagnation in output of key crops and the volatility in agricultural activity, some significant gains have been made in a few areas.

In the industrial sector, there is a growing realisation of productivity and efficiency gains. In the face of free access to imports and foreign direct investment (FDI), Indian industry is increasingly becoming internationally competitive and is aggressively securing access to international markets on the strength of dynamic competitive advantage. The policy environment has also played a role in this resurgence of Indian industry. Tariffs, on a weighted average basis, are comparable to ASEAN levels and taxes on business incomes are internationally comparable. In 2006-07, industrial growth was 11.3 per cent and exports of manufactured goods rose by 16 per cent in US dollar terms (April-January).

The mainstay of the Indian economy is currently the services sector, which constituted 61.9 per cent of GDP in 2006-07 and contributed two-thirds of average real GDP growth for the period 2002-07. The story of India's information technology (IT) capacities is well known. The impulses of growth are now strengthening in other services as well such as engineering and consultancy, communication, entertainment, business, finance and information services as well as a host of personal services

including tourism and hospitality. The Indian development experience is, in fact, regarded by economists as unique in terms of the mutation of growth from a primary economy directly to tertiary activity rather than the conventional path of primary to secondary and then to tertiary stages of growth.

The Indian economy has evolved from a virtually closed economy until early 1980s to one that is opening up and rapidly integrating into the global economy since the commencement of major reforms in early 1990s. In terms of a traditional measure of openness, the ratio of exports and imports (both goods and invisibles) to GDP has risen steadily from 21.1 per cent in 1991-92 to over 50 per cent in 2005-06 and is expected to have gone up further in 2006-07. Both exports and imports have been rising in recent years above the long-term trend. The merchandise trade deficit is currently close to 7 per cent of GDP; however, the current account deficit is under 1.5 per cent of GDP, mainly due to the knowledge and competitive advantage we have in services and the steady support from remittances from Indians working abroad. These factors provide an in-built cushion to the balance of payments and help to keep the current account gap within sustainable limits. In this sense, the Indian economy has not contributed to the current global imbalances.

Since the early 1990s, when we instituted structural reforms widely and deeply with a progressive liberalization of the economy, India has been receiving large capital inflows, reflecting international confidence in the underlying fundamentals of the performance of the Indian economy. The ratio of net capital inflows to GDP has almost doubled from 1.5 per cent in 1991-92 to 2.9 per cent in 2005-06. In recent years, the capital flows have become even larger, accounting for 15 per cent of global net private capital flows to emerging market economies in 2006. There has been a pick-up in the FDI into India as well as borrowings in international financial markets by Indian corporates. Portfolio flows into Indian stock exchanges have shown resilience in the face of two major sell-offs in global equity markets in May-June 2006 and February 2007. An important emerging element in the capital account of the balance of payments is the growing FDI from India (i.e., the overseas investments of the Indian corporates). With the financing requirement of the current account deficit being modest, the rising profile of net capital flows has resulted in steady accretions to the foreign exchange reserves, which have more than doubled from US$ 76 billion at the end of March 2003 to around US$ 200 billion at the end March 2007. While the level of foreign exchange reserves is extremely modest compared to that of Japan, our reserves exceed each – a full year's imports as well as the entire external debt. Since 2002, India has turned creditor to the IMF and has engaged in prepaying external debt.

While the RBI is invested with multiple objectives and is not mandated by law with target/instrument autonomy, the conduct of monetary policy has consistently evolved around the goals of sustained growth, price stability and financial stability, with a continuous rebalancing of weights assigned to each, depending on the evolving macroeconomic scenario. In the recent period, the objective of price stability and well-anchored inflation expectations has been accorded priority against the backdrop of global and domestic developments. It is heartening to note that high growth in the last four years has been associated with a moderation of inflation. The headline inflation rate, in terms of the wholesale price index, has declined from an average of 11.0 cent during 1990-95 to 5.3 per cent during 1995-2000 and to 4.9 per cent during 2002-07. The trending down of inflation has been associated with a significant reduction in inflation volatility, which is indicative of well-anchored inflation expectations, despite the visitations of adverse shocks, both domestic and external.

There is evidence that the widening and deepening of the financial sector, the diffusion of micro structural reforms along with improved regulatory and supervisory oversight have enabled the development of a robust, efficient and diversified financial system with sound and well-functioning financial markets. The combined effects of competition, regulatory measures, policy environment and motivation have imparted greater strength, efficiency and stability to the financial sector. The efficacy of financial sector reforms is also reflected in the significant improvement in the asset quality of the banking sector. Currently, all scheduled commercial banks are compliant with the minimum capital adequacy ratio of 9 per cent. The overhang of gross non-performing assets of scheduled commercial banks has declined from 8.80 per cent of advances in 2002-03 to 3.30 per cent in 2005-06. Operating expenses as a ratio of total assets has declined from 2.24 per cent in 2002-03 to 2.11 per cent in 2005-06.

Developments in monetary policy

A monetary targeting framework was in place in India since mid-1980s and till 1997-98 with broad money (M3) as an intermediate target. In practice, the monetary targeting framework was used in a flexible manner with feedback from developments in the real sector. The Reserve Bank formally

switched over in 1998-99 to a multiple indicator approach. As per this approach, interest rates or rates of return in different markets (money, capital and government securities markets), along with data such as on currency in circulation, credit extended by banks and financial institutions, fiscal position, trade balance, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange, which are available with high-frequency, are juxtaposed with the trends in output, with a view to deriving policy perspectives. The multiple indicator approach made the monetary policy operation more broad-based on a large set of information and provided flexibility in the conduct of monetary management.

As regards the operating procedure of monetary policy in India, reliance on direct instruments has been reduced and a policy preference for indirect instruments has become the cornerstone of current monetary policy operations. However, recourse to direct instruments is taken when warranted by the circumstances. Liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and daily reverse repo and repo operations under a Liquidity Adjustment Facility (LAF).

The liquidity management was further refined in 2004 with the introduction of a market stabilisation scheme (MSS) under which the Reserve Bank was allowed to issue government securities as part of liquidity sterilisation operations in the wake of large capital inflows and surplus liquidity conditions. While these issuances do not provide budgetary support, interest costs are borne by the fisc; and as far as Government securities market is concerned, these securities are also traded in the secondary market, on par with the other government stock.

The Reserve Bank has been actively engaged in developing, widening and deepening of money, government securities and foreign exchange markets combined with a robust payments and settlement system various markets. The medium-term framework is to keep developing the financial markets, preserving the integrity of financial markets and thereby, improving the transmission of monetary policy impulses.

Some of the important developments pertaining to the money market are: First, with a view to transforming the call/notice money market into a pure inter-bank market with participation of banks and primary dealers (PDs) only, non-bank participants have been completely phased out of the call money market. Second, several new financial instruments have been introduced. The traditional refinance support on fixed terms has been replaced by a full-fledged Liquidity Adjustment Facility with a view to modulating short-term liquidity under diverse market conditions. Third, measures have also been taken to make various other money market instruments (such as CDs, CPs, *etc.*) freely accessible to non-bank participants. These measures were intended to improve the depth of as well as the efficiency and transparency of operations in the money market. Fourth, as part of the development of new instruments, a major initiative pertains to Collateralised Borrowing and Lending Obligation (CBLO), which was operationalised as a money market instrument.

As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank as this results in better price discovery and reduces the cost of Government borrowing. This market is also important for an effective transmission mechanism for monetary policy and facilitating the introduction and pricing of hedging products and serve as benchmarks for other debt instruments. Efforts towards development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling market development measures.

Major developments in Government securities market include: establishment of a Delivery versus Payment system to reduce settlement risk; institution of the system of Primary Dealers to strengthen market intermediation; formation of market bodies such as Fixed Income Money Market and Derivatives Association of India (FIMMDA), and Primary Dealers Association of India (PDAI) to improve practices; permission to Foreign Institutional Investors to invest in Government securities in both the primary and secondary markets, with a view to broaden the markets; operationalisation of the Negotiated Dealing System (NDS); and the announcement of an indicative auction calendar for Treasury Bills and dated securities, to help investors plan their investment better and to enhance transparency and stability in the Government securities market.

The RBI has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. Market participants have also been provided with greater flexibility to undertake foreign exchange operations and manage their risks. This has been facilitated through simplification of procedures and availability of several new instruments, e.g., foreign currency-rupee options. Authorised dealers have been permitted to use innovative products like cross-currency

options, interest rate swaps (IRS) and currency swaps, caps/collars and forward rate agreements (FRAs) in the international forex market. There has also been significant improvement in market infrastructure in terms of trading platform and settlement mechanisms.

Financial sector development

The banking sector reforms in India, initiated since 1992 have brought about structural changes in the financial sector by easing external constraints in the working of the banks. Major policy measures include phased reductions in statutory pre-emption like cash reserve and statutory liquidity requirements and deregulation of interest rates on deposits and lending, except for a select segment. The diversification of ownership of banking institutions is yet another feature which has enabled private shareholding in the public sector banks, through listing on the stock exchanges, arising from dilution of the Government ownership. On account of healthy market value of the banks' shares, the capital infusion into the banks by the Government has turned out profitable for the Government. Foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to the prescribed guidelines.

The co-existence of the public sector, private sector and the foreign banks has generated competition in the banking sector leading to a significant improvement in efficiency and customer service. The share of private and foreign banks in total assets increased to 27.6 per cent at end-March 2006 from 24.7 per cent at end-March 2005 and less than 10.0 per cent at the inception of reforms.

The prudential regulatory norms for the banks for capital adequacy, income recognition, asset classification and provisioning have progressively moved towards convergence with the international best practices. The Basel – II capital adequacy framework is being implemented in a phased manner, and the RBI has issued the final guidelines recently. A three-track approach has been adopted for the three types of banks, i.e., commercial banks, cooperative banks and regional rural banks, to facilitate smooth transition. These norms have strengthened the financials of the banking sector, as evident from a decline in non-performing loans and improvement in capital adequacy ratio – despite progressive stringency of the norms. For instance, as on March 31, 2007, nine out of 25 public sector banks have reported zero net NPAs, as a proportion to the total advances. This has been possible also on account of certain legislative and institutional measures implemented to expedite and facilitate the recovery of NPAs through special tribunals and restructuring mechanism. There is an increasing focus on governance aspects in the banks through adoption of "fit and proper" criteria for the owners, directors and senior managers of the banks.

The Reserve Bank has also initiated a number of steps – institutional, procedural and operational – for making the payment systems safe, secure and efficient. For efficiency enhancements and risk reduction, usage of the Real Time Gross Settlement (RTGS) System and other electronic payment mechanisms have been encouraged in a big way. The Reserve Bank has also provided a significant thrust to implementation of information technology in the banking sector.

To strengthen the supervisory framework within the RBI, a Board for Financial Supervision (BFS) was constituted in 1994,comprising select members of the Reserve Bank's Central Board with a variety of professional expertise to exercise "undivided attention to supervision" and ensure an integrated approach to supervision of commercial banks and financial institutions. The Reserve Bank also instituted an Off-site Monitoring and Surveillance (OSMOS) system for banks in 1995, which provides for Early Warning System (EWS) as also a trigger for on-site inspections of the vulnerable institutions. The scope and coverage of off-site surveillance has since been widened to capture various facets of efficiency and risk management of banks.

As we progress further in the reform process, the main focus would be to ensure that the pace of further deregulation and liberalisation remains consistent with the progress of reform in the real and fiscal sectors. In practice, within the given legal framework, priorities have to be appropriately set ensuring implementation of intended reforms in banking sector in tune with the evolving domestic and external developments.

Summing up

To sum up, India reflects diversity; yet there is an overwhelming preference in Indian society and polity for confluence. This is particularly reflected in the stability of the political system, which, in turn, has contributed to macroeconomic stability and sustained growth. Turning to the outlook, growth prospects

of Indian economy have strengthened considerably and appear well entrenched to build on the current momentum. The overarching policy challenge at this juncture is to manage the transition to a higher growth path while containing inflationary pressures. The Reserve Bank's policy endeavor would be to contain inflation close to 5.0 per cent in 2007-08 and in the range of 4.0-4.5 per cent over the medium-term with a view to maintaining self-accelerating growth. The likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum in India complemented by appropriate emphasis on price stability and anchoring inflation expectations.

Let me conclude by expressing my deep appreciation of the kind courtesies extended by the Bank of Japan, and in particular, for the warm hospitality extended by respected Governor Fukui.