# Y V Reddy: Reviving confidence in the Indian economy

First Dr S Radhakrishnan Memorial Lecture delivered by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, sponsored by University Grants Commission and organized by the University of Hyderabad, at Hyderabad on 5 September 2001.

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Respected Vice-Chancellor, Professor Rama Rao, distinguished academics and friends,

At the outset, I would like to express my grateful thanks to Professor Rama Rao garu for giving me the privilege and honour of delivering the first Dr. S. Radhakrishnan Memorial Lecture sponsored by the University Grants Commission and being organised by the University of Hyderabad on the occasion of the Teachers' Days this year. So much has been written and said about Dr. Sarvepalli Radhakrishnan, that any narration by me would do little justice to one of the greatest philosopher-statesman of independent India. An eminent academician, a versatile writer, a brilliant orator, a renowned philosopher, a respected diplomat and a remarkable President of India, Dr. Radhakrishnan had a reputation of weaving a spell on those who heard him. In fact, Bertrand Russell remarked that he had never heard philosophy better expounded than by Dr. Radhakrishnan. Of particular relevance today is not only that Professor Radhakrishnan was a great teacher but also the fact that he served in a vast number of Universities. He had his apprenticeship in Madras and Mysore, went to Calcutta and well before he was forty lectured on invitation at American universities and also at Oxford. He set up Andhra University and was also Vice-Chancellor of Benaras Hindu University. The enormity of respect that he commanded is evident from the fact that the British Government gave him a knighthood; he was nominated to the League of Nations Committee on Intellectual Cooperation; was called to serve on the Constituent Assembly and had a memorable stint as Ambassador to Moscow. I had been lucky as a student to hear Sarvepalli Radhakrishnan in 1954, on a high school sponsored excursion to Delhi; and I still possess the photograph taken with him. Later, as sub-collector, Ongole, I made elaborate arrangements at Chinaganjam railway station for him when he was proceeding to Madras in 1967 after laying down his responsibilities as President. In brief, my personal contact was limited but he remains one of the greatest men I ever met in my life, especially since I started my career as a teacher and once again, yearn to be a teacher.

Speaking of teachers, let me confess that I am here because of an invitation from someone, who like Dr. Radhakrishnan has not only been a teacher but many more things – Professor Rama Rao. An eminent and internationally renowned scientist, a respected head of a regulatory body, a Secretary to Government remembered even after a decade, a builder of institutions, a great contributor to advancement of professional bodies and publications, and one of the finest human beings I have come across. There is lot in common between Prof. Radhakrishnan and Prof. Rama Rao, though one is from the field of philosophy and the other from the realm of science.

Moving from teachers to teaching, the University and Reserve Bank of India (RBI) have assigned me the pleasant task of inaugurating the Master of Technology course in Information Technology, devoted to Banking Technology and Information Security - the first of its kind in India, and perhaps in the world. The pogramme is being jointly launched by the University of Hyderabad (UoH) and Institute for Development and Research in Banking Technology (IDRBT). As per the continuing collaborative activities between the two institutions, a 2 Mbps leased line connectivity has been established between the UoH and the IDRBT with a view to facilitating better and easy communication between UoH and IDRBT, sharing library and other resources at UoH and IDRBT and also providing an avenue for video conferencing. This programme, fully-funded by IDRBT, and open to both direct and sponsored candidates from the banking and financial sectors is a multi-disciplinary programme that seeks to merge the new and emerging technologies in Information Technology with the domain expertise in the ever-changing field of banking and financial services. Providing absolute Information Security and IS Audit systems is a challenge, and is of immediate relevance and concern to banks, especially in the context of current as well as changing business environments in banking, like electronic payment systems, e-commerce, mobile banking, and Internet banking. Deploying of modern and evolving technologies would require the banks to get equipped with requisite skills on a continuous basis. Thus, M.Tech. provides an excellent and right mix of the various aspects of Computer and Information Security that is essential for banking technology to succeed and survive. The Reserve Bank of India, as a sponsor of IDRBT, is happy to be associated with the pioneering and

path breaking collaboration between academia and practitioners and assures full support in its future endeavours for mutual benefit.

In fact, IDRBT has already established a Corpus Fund with a seed amount of Rs. 50 lakh to promote Higher Education and Research in Banking Technology and Management as a core area. Banks and other financial institutions are expected to contribute significantly to the growth of this Fund.

It is customary to devote a Memorial Lecture to a theme, which has fundamental significance and contextual relevance. After consulting with the organisers and keeping in view the interests of the RBI, the subject chosen for this occasion is:"Reviving Confidence in the Indian Economy". It is necessary to recognise that India remains one of the best performing economies in the world, in spite of the current indications provoking a debate on the need for revival of the economy. It can be gathered from the analysis that it is important to revive confidence in the economy in any attempt to improve the performance. An approach in this regard can be discerned from the latest Annual Report of the RBI. In the true spirit of philosophical explorations and interpretations propounded by Dr. Sarvepalli Radhakrishnan, the concluding part of the lecture will be devoted to select structural issues critical to restoration of confidence in the Indian economy.

**Performance of Indian economy**

India today is rated as the fifth largest economy in the world, measured in Purchasing Power Parity terms. Only the U.S., Chinese, Japanese, and German economies are larger than ours. In terms of Gross Domestic Product (GDP) growth rates, India was one of the ten fastest growing economies in the world during the 'eighties, and moved up to the eighth fastest during the period 1980 to 1998. In regard to growth of GDP in per capita terms also, India's performance during the period is among the top ten.

Furthermore, on the basis of data on income or consumption distribution (World Development Report 1998-99) for about 80 countries, and using both the 'Gini' coefficient and the share of the poorest 20 per cent as a measure of distribution, there are only 15 countries in the world, which have a better consumption/income distribution than India.

While growth is considered to be a key measure of macroeconomic performance, economic stability is indicated by inflation. In the 'eighties, India's average inflation rate was close to Asian developing countries, above developed ones and lower than the average for all developing countries. In the 'nineties, inflation has been relatively low in the second half of the decade.

In the external sector, India, along with China, has been described as "an island of stability amidst seas of turbulence" in international currency markets in the recent years.

The ratio of debt to GNP in 1999 was 21.3, the only other developing country with a more favourable ratio being China. India had the lowest proportion of short-term debt to total debt at 4.3, while for China, it was 11.5.

In regard to fiscal position, however, India's fiscal deficit is currently among the highest out of 74 major countries with population more than 10 million. And of these only two are higher than India. Furthermore, public savings in the 'nineties in India, which reached its peak of 2.0 per cent of GDP in 1995-96, became negative 1.2 per cent of GDP by 1990-2000. The average rate of financial saving of the household sector and of private corporate sector generally moved up during 'eighties and 'nineties. There is also evidence of decline in the incremental capital output ratio (ICOR) from 4.2 in the 1980s to 3.9 in 1993-2000.

There has also been an appreciable decline in poverty. The all-India poverty ratio fell to 27.09 per cent in rural areas, 23.62 per cent in urban areas and 26.10 per cent at the all-India level in 1999-2000 from 53.1 per cent, 45.2 per cent and 51.3 per cent recorded during 1977-78.

Life expectancy has also moved up from 50.4 years in 1980-81 to above 61 years in the 1990s. There has been an improvement in the life expectancy at birth for males from 50.9 years to 60.4 years and for females from 50 years to 61.8 years.

The overall literacy has increased from 43.7 per cent in 1980-81 to 63.1 per cent in 1998-99.

Moreover, for the first time in four decades, population growth has decelerated to below 2 per cent and this has been accompanied by a decline in the mortality rate from 12.5 per 1000 in 1980-81 to 8.7 per 1000 in the 1998-99.

Yet, there is a sense of impatience if not despondency at our economic policies. The reasons are fairly obvious. We start from a low base of GDP from which impressive rates of growth are noticeable. India still accounts for a very large concentration of poverty and of illiteracy, and hence fruits of development either may not reach or are inadequate. While employment in organized sectors has virtually stagnated, in recent times, insecurity in employment has crept in. Skill-irrelevance of most of the manpower to the emerging needs has a depressing influence, especially when coupled with downsizing. Moreover, significant and accelerating expectations have been created. There is widespread awareness of the capacity of the economy to grow rapidly and they see no apparent reason for slower than possible growth.

There are, thus, discernible reasons for the current debate on revival of the economy, centering around the recent deceleration in the rate of growth, and certainly going beyond the simple exhaustion of animal spirits of the business community in the country.

**Why the current debate on revival of Indian economy**

First, the deceleration of economic activity for the second year in succession has raised some concerns about the feasibility of rapidly moving the economy to a higher growth path in the medium term. Added to this is the public perception that India is not immune to the slowdown phase of the global business cycle.

Second, the agricultural sector has exhibited considerable volatility and recorded absolute declines in the last two quarters of 1999-00 and again in the first quarter of 2000-01. Agricultural production registered a negative growth on top of a decline in the previous year.

Third, the growth of industrial production decelerated during 2000-01and further to 2.1 per cent in the first three months of 2001-02 from 6.1 per cent in April-June 2001.

Fourth, services sector, which accounted for a major share of GDP, exhibited a lower growth of 7.5 per cent in 2000-01 as against 9.4 per cent in 1999-00.

Fifth, there has been lower off-take of nonfood credit from the banking system, especially since January 2001.

Sixth, imports declined by 0.2 per cent in 2000-01 as against an increase of 17.3 per cent during 1999-00. Non-oil imports declined by 8.5 per cent as compared with the increase of 3.2 per cent in 1999-00.

Seventh, export growth decelerated sharply to 1.7 per cent in April-June 2001-02 from 26.6 per cent in the three months of 2000-01.

Eighth, considerable uncertainty, arising from turbulence in stock exchanges and apprehensions of liquidity/payments problems, the problems in some cooperative institutions and the largest mutual fund, the downgrading of the rating of a major development financial institution and the repayment problems faced by another financial institution, has affected investor sentiment.

There are, however, some favourable developments in the economy that need to be highlighted to get across the major thrust of the argument viz., the current issue is significantly one of confidence, especially on the prospects.

First, real GDP growth when viewed in the context of the growth of other countries, is still one of the highest in the world.

Second, inflation has remained stable and low.

Third, the financial sector has experienced declining interest rate environment.

Fourth, despite turbulence in the stock markets, the other segments of the financial markets have remained stable and there have been no serious threats to systemic risks.

Fifth, the external sector is clearly sustainable with the current account deficit continuing to be less than 1 per cent of GDP.

Sixth, foreign investment sentiment does not seem to have been affected with FII inflows recording about $750 million during April-July 2001 as compared with $ 150 million during April-July 2000.

Seventh, the record level of foreign exchange reserves at nearly $ 45 billion on August 24, 2001, stable exchange rate and money market rates provide less risky business environment.

Eighth, foodstocks have reached an all-time high, improving food security and immunising the economy from transient supply shocks.

### An approach to revival of confidence

It is customary for the Reserve Bank of India to present an Annual Report each year and that Report for 2000-01, was approved by its Board of Directors on August 16. The Chapter on Assessment and Prospects sets out a carefully constructed statement of the RBI Board's perspective and this provides a useful starting point to debate what needs to be done to revive confidence in the economy.

While noting the comfortable position of external sector and the possible moderate impact of global developments, the need for addressing the predominantly domestic factors is flagged.

The present state of the economy reflects a combination of cyclical and structural factors with different weights assignable.

The implication is that any solution should address both the cyclical and structural issues, though the relevant importance and sequencing of the various components will have to be well crafted.

In regard to structural factors, a particular mention is made of the operation of the institutional constraints on growth. The suggestion is that the legal framework and institutional arrangements would have to be accorded priority in the structural component.

As regards the relative role of macro economic and micro economic considerations, it is made clear that both require to be addressed, but the Report focuses on importance of micro economic aspects in as much as they are closely linked to institutional factors.

The balancing of the reform in financial and non-financial sectors is also highlighted and the importance of accelerating the reform in real sector, particularly agriculture, is stressed.

More specifically, recognising that a large segment of the population is dependent on agriculture and its performance in the recent past has been of considerable concern, the importance of augmenting public investment in agriculture is emphasised.

In particular, the advantage of shifting public expenditures from subsidies to investment as a means of efficiency, equity and regional balance is pointed out. Furthermore, desirable measures for the creation of an efficient system of market intermediaries, quality-enhancement, perhaps through certification, introducing insurance mechanisms, developing nation-wide multi commodity exchanges, etc., are listed out. In a sense, therefore, the emphasis is on attaining a quantum jump in the agricultural sector to meet global standards as a means of withstanding global competition and taking advantage of emerging opportunities in international trade.

With regard to industry, the fact that public sector enterprises still dominate the economy is noted and a strong plea is made to end uncertainties in regard to the future of public sector enterprises. In particular, the complementarities in public and private sector are emphasised.

The thrust is that enhanced resources should be made available to select public enterprises, which have strategic significance or strong public purpose, while clearly and promptly disinvesting Government's equity in the other enterprises. At the same time, the creation of a conducive environment for industrial revival warrants an appropriate regulatory framework to improve infrastructure. By implication, one of the approaches advocated is that if labour has to be compensated, it should be done directly rather than incurring open-ended non transparent expenses in the name of revival, through tax concessions, sacrifices by financial institutions and incentives to induce sickness.

Finally, in the context of the new economy, the emphasis is on removal of procedural and institutional constraints, thus warning against bureaucratization in the name of creating enabling environment.

In the external sector, there is considerable cause for comfort emanating from reasonable level of reserves, low current account deficit and adequate level of capital flows, but the need for continued caution and vigil is rightly noted. Above all, in the current account, improving the export performance and in the capital account, attracting FDI are highlighted as necessary for medium-term sustainability. By all accounts, the major constraints in regard to both these appear to be the institutional framework

and uncertainties in regard to the policy framework, both of which need to be tackled urgently as part of confidence boosting measures.

On fiscal policy, the major thrust is towards *fiscal empowerment* in contrast to *fiscal enfeeblement* to realise the objective of durable fiscal consolidation. This would call for several steps to increase the tax revenues, abolish tax exemptions, enhance the non-tax revenues by ensuring cost recovery, etc. A case is thus made out for either obtaining adequate return on investments in public sector enterprise or for disinvestment, unless a specific purpose in the interest of the public at large is served better by public ownership.

In regard to public debt, a point is made that the size of government borrowings, though most visible, is not the only one element in public debt management. Keeping in view the fact that only 80 per cent of the central government's liabilities are covered by assets even as per the government accounting system which is cash based, the health of public finances is linked to the both formal guarantees, and implicit guarantees. In other words, wherever the government is owner, directly or indirectly, there is an inevitable obligation on the part of the government to the discharge of liabilities in order to avoid reputational risk while declaring a government owned enterprise as insolvent. In brief, a holistic view of assets and liabilities as well as incomes and expenditures of the public sector as a whole is canvassed in the report, which would warrant significant importance to accounting practices, disclosure standards, and a degree of transparency in public sector as a whole.

In the matter of interest burden, the Annual Report makes a reference to several proposals under consideration to focus on instruments that currently result in very high effective cost to the Government. Another area of concern, though not elaborated in the Report is the element of a *Ponzi* scheme in small savings at high cost to the Government with a tendency to finance the ballooning fiscal needs of State Governments, while imposing serious mismatches in the asset-liability maturity profile of the Central Government.

The concept of fiscal impairment is clearly of special significance for States since the bedrocks of socio-economic welfare viz. law and order and social services are in the state sector. The actions needed would, therefore, be in terms of expanding public goods and social services including anti-poverty programmes with concomitant roll-back of fiscal activism in commercial activities.

In regard to monetary policy, the major emphasis is on flexibility of interest rates in the financial system as a whole. The global developments in terms of oil prices and the domestic developments in terms of inflation emerge as important areas to monitor in the conduct of monetary policy. While a number of instruments have been devised and operating procedures have undergone significant changes, it is very clear that considerable sophistication and skill are essential in successful conduct of monetary policy.

As regards financial sector, several problems warranting attention are brought out. These relate to perception of implicit sovereign guarantee in regard to all financial intermediaries, and lack of arms length relationships and lack of clear demarcation between ownership and regulation. In particular, there is a reference to complexities arising out of existence of various types of financial intermediaries with differing charters owing their origins to prereform strategies, which virtually calls for a thorough revamping of the interface of government and Reserve Bank with financial intermediaries that they own. Above all, the inadequacies in the present banking system, particularly in the cooperative sector, in meeting the credit needs of agriculture as well as small and medium industries necessitate a fundamental change in the systems of their governance and functioning.

### Exploration of some measures

There is a strong consensus among international observers that there is a weak reform process in India, which expresses itself in the form of relatively slow implementation of policies. Another view is that the "tyranny of ten per cent", namely the workforce of the organised sector, continues to resist any change. Yet another view is that in any democracy, reform is generally a slow process since the sacrifices of the vociferous minority come upfront while the benefits to the vast but relatively silent majority accrue with a time lag. Perhaps, there are elements of truth in each of these views, but without doubt, the relevant issues are essentially in the nature of political economy and not merely matters for technical analysis. Yet, there is merit in exploring some drastic measures, which could demonstrably improve the current sentiment.

Reviving the economy requires boosting of confidence by combining both structural and other cyclically relevant measures. While the latter are desirable, such measures must be combined on a credible basis with structural measures. In this address, it is not proposed to elaborate on either cyclically relevant measures or the process of integrating them with structural measures, but confine to structural issues.

It is possible to be illustrative and certainly not exhaustive even in regard to the structural measures. The intention is to express purely exploratory technical views in five of the areas that are critical, namely, financial sector, regulatory framework, public enterprises, delivery of public services, and overhang issues. These do not in any way constitute the official position of RBI.

**Advisory on financial sector restructuring**

It is useful to understand some features of the financial system in India. Most of the financial savings still comprise deposits to the banking sector, with some perceptible flow to life insurance, mutual funds, government small savings and Provident Funds. About three quarters of the banking deposits go to government owned banks that currently have invested over one-third of the assets in government securities and a perceptible amount in PSU bonds, development financial institutions cooperatives and government guaranteed enterprises. This gives place to a criticism that government owned banks are operating as instruments to finance high public sector deficits. Similar arguments can be advanced in respect of the largest mutual fund, viz., the Unit Trust of India and the insurance giant Life Insurance Corporation of India not to mention the General Insurance Corporation. While Industrial Development Bank of India is a public sector statutory corporation, Industrial Finance Corporation of India's major shareholding is by government owned Institutions. Industrial Credit and Investment Corporation of India is a public financial institution and hence has a special status accorded by Government.

While public tend to repose confidence in these institutions by virtue of their status as Government-owned or backed entities, there is corresponding implicit direct obligation on the part of the Government to protect the interests of depositors/investors. In other words, any vulnerability in regard to these institutions has an impact on government's finances. Such a reasonable expectation is not only justified on the consideration of the concept of "holding out" a backing, but also by the obligations discharged in the past by Government of India in several cases including the case of CanFina through Canara Bank.

The regulators of financial sector have some additional complexities in relation to public sector entities. First, in the case of statutory bodies including public sector banks, there are certain regulatory constraints. For instance, both for reasons of legality and reputational risk, the regulator cannot cancel a licence, say to a public sector bank, even if it fails to meet capital adequacy norms. The recourse open to the regulator in the case of owner's unwillingness to inject capital to meet capital adequacy standards is unclear and this often leads to regulatory forbearance. Second, as in the case of UTI and Development Financial Institutions, the legal basis of jurisdiction of regulators is somewhat ill-defined. Thirdly, Government tends to be closely involved in some operations of many of these institutions' and overlapping of accountability is plausible. Fourthly, as long as these institutions function without reference to sound principles of corporate governance though consistent with their individual statutes, inherent weaknesses persist. In fact, where there has been disinvestment and consequently some shares are held by the public, minority shareholder interests are not seriously factored in. Fifthly, the Government expects the regulator to often function as an agent of owner (Government), which further complicates accountability. Finally, the regulatory focus in respect of these institutions as set out by Government itself is not well defined and diffused. The issue is whether defining the respective roles and making their transactions more transparent would improve confidence in the financial sector by avoiding the criticism that they often take recourse to lending, investment, rescheduling and bailouts, and extending guarantees as behest operations. It is against the above background that institutions tend to be somewhat less than responsive to regulatory regime as well as market discipline.

Furthermore, the non-performing assets (NPAs) arising out of priority sector lending, which is in the nature of directed lending and those covered by the Bureau of Industrial and Financial Restructuring (BIFR) together account for well over fifty per cent of total non-performing assets of the banking system. The number of companies referred to the BIFR by three major Development Financial Institutions (DFIs) stood at 694 with a total loan outstanding of about Rs.6,275 crore as at end-March 2000. Above all, in view of their close interrelationships, the risks of contagion are high and hence the need to overhaul them to inspire confidence.

It is essential to recognize the constraints under which these entities are operating in a highly competitive environment induced by the reform process. Apart from the issues of diffused accountability to the Government and regulator and multiple objectives to be pursued in order to justify public sector nature, their management style is occasionally cramped by extraneous interventions. As a consequence of all these factors, at operating levels of these entities, there may be a strong incentive to inaction than action.

It would be totally inappropriate to conclude that these institutions are more vulnerable now than before. In fact, their vulnerabilities were neither defined nor measured in the past and the pressure built on them by the financial regulators in the recent past has enabled them to improve their functioning and disclose their real status. The dimension of the problem which were concealed is being revealed and there is perhaps a strong case for admitting and assessing the real status, and take corrective actions to meet the overhang issues and design strategies to make the future operations efficient, stable and accountable.

In regard to private sector banks including cooperatives, vulnerability of some of them is no longer an impossible contingency. Hence, an interesting question that can arise is the appropriate response that is justifiable in case there is a run on such a bank. The primary responsibility of the regulator is two-fold, viz., protection of small depositors and avoidance of contagion resulting in systemic risk. In case of such problem, the regulator should attempt to identify whether it is due to illiquidity or an insolvency problem. In case it is assessed as an illiquidity problem, the regulator may in exceptional cases act as a Lender of Last Resort and consider infusing temporary liquidity to such a bank to tide over the problem of mismatch. In case it is assessed by the regulator that a bank is insolvent or the bank itself closes its branches for banking operations, the logical requirement would be liquidation unless a serious contagion resulting in systemic risk is anticipated. A prompt liquidation operation, whenever warranted by these considerations would ensure two aspects. First, retail or small depositors upto Rs. 1 lakh would be able to recover their deposits quickly (perhaps in matter of days) and secondly, depositors with over Rs. 1 lakh deposits would need to book losses. In particular, corporates or institutions that have placed deposits in banks may have vested interest in prolonging the matter even at the cost of small depositors in order to avoid disclosure of losses in their balance sheets. Under these circumstances, the regulator has to make difficult decisions/judgments at short notice, often with incomplete information. Sometimes, liquidity and solvency issues get intermingled with discomfort to the respective regulatory arms.

In India, very often, in case of such banks, for a variety of reasons, a softer approach is taken and sometimes legal hurdles are faced. It is possible to argue that this soft approach has resulted in a typical situation of moral hazard when the management tends to become inefficient and depositors do not exercise adequate prudence. The depositors in banks should be encouraged to exercise at least as much caution, attention and time when they place deposits as they do when they purchase vegetables. Thus, a clearer enunciation of effective policy in regard to vulnerable banks would enable swift action by the regulator and exercise of more caution by depositors. In this context, insistence on greater disclosure and the regime of Prompt Corrective Action would be relevant.

To put it differently, the current priority for policy should be to clarify the relationships between the regulator, regulated, owner and government as well as a well-defined regulatory focus to enable healthy development of financial markets. Perhaps, this needs even more urgent attention than a debate on single versus multiple regulators. My experience as Chairman of Standing Committee on International Standards and Codes has provided a clue for this purpose in the form of Advisory Groups. On the same analogy, the highest level in the country say the Prime Minister or the National Development Council could constitute an independent *Advisory Group on Financial Sector Restructuring* with eminent non-officials as members and the officials should be available only to facilitate the work of such bodies. Such an advisory body should be able to produce a blue print within few months since substantial international experience and domestic research are already available in this direction.

### Zero regulation

As mentioned, one of our major achievements in this decade has been the strength and successful management of the external sector. There are some lessons to be learnt from the experience. First, there was initially a fear that liberalisation of imports and delinking financing of imports with import licensing would result in a surge in imports, but a few argued that such fears were unfounded and, in fact, the import bill would be down. The results vindicated the views of the few liberalisers viz.,

inventories went down as uncertainties in administration of import-regime were removed; moreover, users of imports could try out and experiment with domestic supplies without diluting their rights to import (since import permit was both on entitlement and on commitment). Second, import of gold was virtually prohibited on the ground that gold is unproductive and hence precious foreign exchange should not be wasted on it. A few argued that there is a strong sentiment in favour of gold in India (for mangala-sutra, for streedhan, as both a consumption and investment good) and hence was imported in any case through unofficial channels resulting in significant trade and currency transactions beyond the pale of policy and law. The argument of the few that allowing of import of gold liberally will eliminate such unofficial transactions both on receipts and payments side of the current account, reduce the outflow of forex for transaction costs and improve the effectiveness of policy of exchange rate management has been fully vindicated. At the same time, the caution expressed by the very same few in regard to capital flows has also helped India in withstanding the volatility of international flows. It is not the case that there are no anomalies left in the management of the external sector. For example, while an Indian resident has the option of spending a generous amount of foreign exchange on a holiday abroad or liberally send gifts, a resident is not permitted to use the same entitlement to acquire a foreign financial asset. It must be relevant to recognise that the liberal regime for individual residents on current account has not revealed any major abuse of the facilities or any major drain in terms of foreign exchange outgo. Similarly, a tourist in India too is discriminated in airlines and hotels to the extent payment has to be higher and in foreign currency, thus giving a signal that the Rupee is not a valid currency for some transactions within India. The thrust of the argument is that appropriate deregulation and well crafted restrictions are key to successful policy, and in India such an approach is feasible when policy makers and bureaucracy recognise that they are dealing with people with their preferences, prejudices, responses, etc., and that every regulation needs to be justified that its demonstrable benefits exceed the costs of administering regulation and overall costs of compliance with regulation.

It is heartening to note that the Prime Minister has recognised the enormity of the issue of institutional impediments in the revival of economy when he declared before the meeting of National Development Council on September 1, 2001 : “We must quickly identify and eliminate all perverse laws, regulations and procedures which lead to unproductive activities, cost increases and sap the energies of the entrepreneurs".

In order to operationalise the suggestion, Parliament or Government may consider establishing *“Zero Regulation Advisory”*, a person or a Committee of eminent non-officials who would take on board any questioning of any regulation or Law as excessively intrusive or costly or unnecessary. It can also accept suggestions for modifications or alternatives. The regulator concerned would have to justify continuance of such a regulation to the satisfaction of the Committee. The advise of the ZRA, which should be made public should be binding unless countermanded by a public speaking order by the authority appointing the ZRA. The experience of Reserve Bank with Regulations Review Authority, though somewhat circumscribed, is very instructive in this respect. For example, ZRA could designate *Regulation Review Outpost* in each regulatory organisation, somewhat on the lines of the Chief Vigilance Commissioner designating vigilance officers in various Ministries and organisations, though the reporting and work methods would have to differ. No doubt, the ZRA would have jurisdiction over the regulatory organisations also. Such a system needs to be applied for legislation also since most of the enactments do not contain what are known as “sunset clauses”. While advocating zero regulation as a process at this juncture as part of general review, it is essential to devise and strengthen appropriate and credible regulatory framework wherever essential, such as in regard to physical infrastructure.

### Portfolio management approach

As explained in the current Annual Report of RBI, the public enterprises are uncertain about their future and are starved of capital due to fiscal stress, both factors seriously affecting their morale. The uncertainties in regard to the policy intentions as well as market response to disinvestment add to lack of capital formation and sub-optimal performance. Moreover, experience indicates that Ministries lack the incentive to divest, and even when they do, lack the expertise to see through the process. While budgetary compulsion appear to give a push to disinvestments, in the process, several distortions may take place such as selling shares with assurances of monopoly, selling minority share-holding, intra-public sector transactions giving an erroneous impression of disinvestments, etc. Unfortunately, all these tendencies, especially delayed processes could lead to loss of output in public enterprises, reduced income to Government, adverse impact on workers, contagion to financial sector, especially

public sector banks and erosion of share holder value culminating in possible deterioration of family silver into family junk.

It must be noted that the functioning of the public enterprises impacts the fiscal situation both on a continuing and contingent basis. The relationship between Government and Public enterprises as also among the enterprises has followed and are still following what has been described as the joint family approach, which undermines transparency and accountability. The examples of input-output relationship between coal production, railways, steel making, power generation, public sector banks and insurance companies are enough to indicate the potential for operations at the behest of non-commercial considerations, many of which are not even properly accounted for in their respective balance sheets, profit & loss account etc. in a mutually consistent manner. Such linkages may have persisted in the long process of disinvestment that has been undertaken. Considerable progress has been made in imparting transparency and accounting for transactions on commercial considerations, but the process is far from complete.

It is possible to enunciate some ground rules for defining the future of public enterprises (both financial and non-financial) on the basis of what may be termed as Portfolio Management approach. First, whenever a private operator is permitted to enter an activity and compete with an existing public enterprise, the unique rationale for continued public ownership is eroded as such enterprises form part of commercial investment portfolio of government.

Secondly, the Government should have the prerogative and obligation to elaborate and define considerations that determine non-commercial characteristics warranting public ownership on a subsisting basis.

Thirdly, all enterprises in commercial investment portfolio have to be operated on commercial considerations and shareholding may be continued, reduced or expanded on commercial (which includes financial) considerations alone. To ensure this, ownership of all such enterprises need to be transferred to what may be termed as *Portfolio Management Company of India* (PMCI). No doubt, the organisational forms of all such enterprises would be companies under Company Law totally on par with other competing entities. This procedure recognises that while Government or Ministry has the responsibility to decide on public purpose of an entity, disinvestment or operations of a commercial entity require different set of expertise and processes.

Fourthly, PMCI would assess the expected cash flow over the years with continued total or majority or minority ownership *vis-à-vis* the capital receipts expected from disinvestment, from time to time. Naturally, the cost of funds for Government and by extension to PMCI will be a consideration. In other words, the PMCI will replace the present advisory Disinvestment Commission and will operate as an independent portfolio manager.

Fifthly, public interest considerations such as strategic presence and protection of interests of labour in respect of each enterprise will have to be specified and mandated by Government while transferring enterprises to the PMCI.

Sixthly, PMCI will have the flexibility to provide financial resources to those enterprises which can perform well or those which have the potential to increase shareholder value.

Clearly, while the decision as to whether any enterprise should be in public or private sector is a policy decision to be made by Government at higher level, in respect of those enterprises which are purely in a commercial but competitive environment, the process of expansion, strengthening or disinvestment are essentially operational matters and hence best carried out by professionals with due regard to dynamics of the market and securities regulation. This should ensure that the total investment portfolio of the commercial enterprises of the government is managed efficiently reconciling commercial objectives and sound fiscal management. This in brief is the logic behind the proposed PMCI.

## Bypass and delivery of services

The importance of fiscal adjustment at State Level in enhancing the output and quality of services has been recognised. The popular perception of effect of reform and thus confidence in the economy appears to have been undermined by the deterioration in the quality of public services be it education or health or even drinking water. While a generation ago, most of these facilities were sought and provided in the government sector, today, a large part of some of these facilities is available only on commercial basis. Consequently, many, especially the poor are deprived of reasonable or in any case equitable access to these services. In fact, even security of buildings is getting increasingly privatised

in urban areas. In other words, there is a phenomenon of “bypass" of these public services since the main arteries appear choked, on which enormous sums are spent by Government. There is sometimes a tendency to spend energies in regulating the bypass activities for ostensible public purpose than on improving the quality of services in public domain. While superfluous regulatory aspects would be considered by the proposed ZRA, there is a need for assessing, on a continuous basis, the cost of inputs and the quantity as well as quality of output in regard to delivery of these public services. Perhaps, it is possible to devise mechanisms under the aegis of the Comptroller and Auditor General to make such assessments on a continuing and scientific basis, by outsourcing as is being done in respect of commercial audit of public enterprises. Indeed, the audit of delivery of such public services deserve far greater energies and attention than many other sectors.

It is hoped that media and academia would join in such efforts to assess these sectors, which are critical to the nation’s well being.

**Overhang issues**

It is necessary to make a distinction between what may be termed as “flow” issues and overhang issues. There is merit in insulating the overhang problem from flow issues and demonstrably solve the flow problem upfront. For example, in regard to food stocks there is addition to buffer stocks virtually on a continuous basis and a policy needs to be evolved to tackle this flow. Any attempt to sort out the overhang accumulated excess stocks on an *ad hoc* basis would obviously have limited success. Any solution to the overhang problem of large magnitude is bound to be operational over the medium-term and may involve admission of the magnitude of possible losses to be incurred. Yet another example relates to the power sector, where addition to capacities to generate without ensuring cost recovery adds to the problem of accumulated losses. *Prima facie*, the other major areas with considerable overhang problems are financial sector, public enterprises, pension and provident liabilities and the cooperative sector. Since many of these issues require well crafted medium- to long-term actions, it may be necessary to define the goals specifically and negotiate the process rather than move forward in an *ad hoc* manner. In other words, disjoined incrementalism may not be mistaken for sequencing of reforms and there is merit in coming clean, defining destination and negotiating as part of political process, the arduous but rewarding journey towards the sustainable and credible progress towards a modern, humane, prosperous and egalitarian society.

Perhaps, Dr. Sarvepalli Radhakrishnan, the philosopher – Statesman – teacher would have endorsed such a transparent but consensus based approach.

Thank you!