

INVESTMENT, GROWTH AND REFORM : INDIA EMERGES

Keynote address by

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GLOBAL ISING INDIA'S FINANCIAL SECTOR: ISSUES IN BANKING, FINANCE AND CAPITAL MARKETS

Distinguished guests, Ladies and gentlemen,

Let me, at the outset congratulate Institute for International Finance (IIF) for inviting RBI to this august gathering. IIF has been instrumental in publishing several documents on the Indian economy, the most recent being *possibly* a country report sometime around March this year. And let me add that I am delighted to share my experiences and distil from the experiences of other luminaries.

In recent times, there has been growing concern worldwide about the need for preserving financial stability. Prior to the onset of reforms in 1991, the erstwhile Government-dominated financial system was, so to speak, imparting too much stability, possibly at the cost of efficiency. The central philosophy behind the process of financial sector reforms in India since 1991 has been the recognition of efficiency gains in the financial sector as endogenous sources of growth. Such efficiency gains were attempted through a shift in the development paradigm reflected in a redefinition of the role of the State in the economy. As the dominant fear of market failure receded, the process of financial sector reforms saw a decisive shift towards market-oriented strategies, enabling price discovery through deepening of the financial system with multiple and diverse financial entities of different risk profiles. The process of financial liberalization resulted in innovations in instruments and processes, technological sophistication and increased capital flows. In this context, the pursuit of financial stability in India, viewed from the standpoint of financial sector, has hinged on three pillars:

- Ø ensure uninterrupted financial transactions;
- Ø maintain confidence in the financial system amongst all stakeholders and
- Ø contain excess volatility that could unduly and adversely affect real economic activity.

Judged thus, interest in financial sector reforms in India as also elsewhere around the globe has gained prominence from the standpoint of preserving financial stability. It is by now well recognised that the Indian economy has come a long way ever since the initiation of financial sector reforms in the early nineties.

In the keynote address, what I would attempt to do is to trace the broad trends in the global financial system with specific attention to emerging market economies and in the light of the same, highlight certain issues germane to the Indian financial sector at the present juncture and the way RBI has been going about addressing these concerns. The speech will be divided into three broad sections. In the first section, I shall touch upon major issues in Banking and Finance internationally and where India stands in comparison. The second section will focus on the capital markets while the third section will highlight the process of liberalisation of India's external sector and integration of the Indian economy with global markets.

I. Banking and Finance

When we look at the major features of international banking and financial scenario, the following characteristics come immediately to mind.

First, in terms of **the structure of the industry**: the number of large and medium domestic banks¹ tends to be much larger in developed countries as compared with emerging economies.

Second, the **share of bank asset** in total financial sector asset. In most emerging markets, given the dominance of banks in the financial system, bank

¹Defined as the number of banks ranked in the world's top 1000.

assets comprise a significant proportion of total financial sector assets, whereas these figures are much lower in developed economies.

Third, **industry concentration**, measured by the percentage of a country's banking sector assets controlled by the largest banks. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. According to the BIS, in 1999, the share of assets held by the five largest institutions was 43 per cent in East Asia and 59 per cent in Latin America.² These figures tend to be much lower in developed economies.

Fourth, the **internationalisation** of banking (i.e., the share of foreign-owned banks as percentage of total bank assets) has increased significantly in recent years. For example, in Eastern Europe, the share of banking assets under foreign control increased from 25 per cent in 1995 to 30 per cent in 2000. In Latin America, almost 40 per cent of total bank assets was controlled by foreign banks in 2000, following a series of cross-border mergers and acquisitions. Indonesia, Korea and Thailand have also raised allowable foreign equity levels in local banks to 100 per cent.

Finally, the **share of state-owned banks** in total banking sector assets. Emerging economies, with predominantly Government-owned banks, tend to have much higher state-ownership of banks. Illustratively, in 2000, the share of state-owned banks was well over 90 per cent in China and in the range of 12-30 per cent in Asian economies such as Korea, Philippines and Thailand.

Added to these, the process of **consolidation**. The most notable difference between the consolidation process in developed *versus* emerging markets is the overwhelming nature of cross-border mergers and acquisitions in the latter.

Having highlighted the major features of international banking, the question immediately arises: what strategies can be adopted by Indian banks to become and remain globally competitive? Though there is no single *mantra* to

² BIS (2001), *The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability*, BIS Paper No. 4, August.

become globally competitive, let me attempt a few possible observations on this count.

The first is the issue of **consolidation**. My earlier observations would suggest that consolidation is now a buzzword in the banking industry worldwide. The legal dimension of the aspect in India was highlighted by Governor Dr. Y.V.Reddy in his BECON Speech in December 2003 in Mumbai. Let me give you some figures to highlight the point. According to *The Banker 2004*, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. The largest bank in China with an asset base of over US \$400 billion. In contrast, the total asset of the largest two banks in India, one in public sector and another a private entity, are US \$127 billion and US \$29 billion. These figures are extremely illuminating and the onus is on the banks to take cognisance of this fact. The Government has raised the cap on FDI in private banks. The RBI has, on its part, suggested certain changes in the *Banking Regulation (Amendment) Bill, 2003* that seek to address some of the legal impediments arising in the consolidation process.

The second issue of import is that of **management of costs**. Cost containment is a key to sustainability of bank profits as well as their long-term viability. In 2003, operating costs of banks, expressed as per cent of total average asset, was lower than 2 per cent in major European economies like Sweden, Austria, Germany and France. In contrast, in India, in 2003, operating costs of commercial banks were 2.24 per cent of total assets. The downward stickiness continued in 2004 as operating costs have remained well above 2 per cent, as percentage of total assets. If we combine this fact with bank size in these economies, the evidence comes across loud and clear.

Related to the aforesaid point is the cost of funds of the banking sector.³ In tandem with the soft interest regime over the last few years, cost of funds of the banking sector has been declining. Illustratively, the cost of funds of public

³ Cost of funds=[(Interest paid on deposits *plus* interest paid on borrowing)/(Deposit plus borrowing)]

sector banks, which was 6.9 per cent in 1995-96 has since declined to 5.0 per cent in 2003-04. Other bank groups have also experienced concomitant declines. With the rise in oil prices and its cascading effects on inflation along with the raising of policy rates by several central banks, sooner or later, this reversal of the existing comfortable liquidity conditions is likely to have ramifications on domestic financial markets, and with that, on the cost of funds of banks as well. Diversification into fee-based activities coupled with prudent asset liability management hold the key to future profitability.

The issue of **credit systems** has come into focus of late. The persistence of divergence between the informal and formal sector interest rates in effect has meant that, with deregulation, the formal credit mechanisms have not been able to pierce the informal system. The differences in ‘apparent cost’ and ‘total real cost’ might be an important factor behind this divergence.⁴ Reducing the ‘total real cost’ in the formal sector is likely to be an important consideration to bring about a degree of convergence between the price of credit between the formal and informal sectors. In recognition of this fact, the last several Annual policies have placed explicit emphasis on streamlining credit delivery through a gamut of measures, including, among others, widening the scope of infrastructure lending, revamping the rural credit delivery system by envisaged restructuring of the rural banking segment, widening the scope of priority sector lending, and the like. I am sure that Indian banks would be up to the task to address the issue of credit delivery.

The fourth issue is the **management of sticky assets**. This is a key to the stability and continued viability of the banking sector. Although, the ration of nonperforming loans to total assets are higher in comparison to international standards, the Indian banks have done a marvellous job in containment of non-performing loans (NPL) in recent times. Non-performing loans to total loans of banks were 1.2 per cent in the US, 1.4 per cent in Canada and in the range of 2-5 per cent in major European economies. In contrast, the same for Indian banks

⁴ ‘Apparent cost’ is what is shown in the loan document, whereas ‘total real cost’ includes cost incurred on formalities, including documentation (number of photocopies required, the paper work, transportation cost, etc.)

was 8.8 per cent. Gross NPL ratio for Indian scheduled commercial banks declined to 7.3 per cent in 2004 bearing testimony to the serious efforts by our banking system to converge towards global benchmarks. In fact, recovery management is also linked to banks' interest margins. Net interest margins of scheduled commercial banks in India was 2.8 per cent in 2003, whereas it stood far lower in the range of 0.6-2.4 per cent at major European and Japanese banks.

The fifth issue concerns the **management of risks**. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II has, through their various publications, provided useful guidelines on managing the various facets of risk. I believe institution of sound risk management practices would be an important plank for staying ahead of the growing competition. Over the past few years, the Reserve Bank of India has initiated several steps to promote adequate risk management systems across market participants. Among the measures that were instituted to insulate the financial institutions from the vagaries of the market were gradual increase in the cushion of capital, frequent revaluation of the portfolio based on market fluctuations, increasing transparency and a framework for asset liability management (ALM) to combat the risks facing the Indian financial Sector. The RBI has taken a lead in providing guidance to banks by bringing out guidance notes on how to identify, monitor, measure and control the various facets of risks. However, in the ultimate analysis, the onus is on the banks themselves to adopt an integrated risk management approach, based on coherent risk models suited to their risk appetite, business philosophy and expansion strategies. Such improved risk management systems are not only crucial stepping stones towards Basel II but also are expected to enable banks to shed their risk averse attitude and contributing more finance to hitherto unbaked segments of agriculture, industry and services. It is important that banks look at the expansion of the credit portfolio in a healthy way, particularly in the

background of higher industrial growth, new plans of corporate expansion and higher levels of infrastructure financing.

It must be noted in this context that for active players in the Government Securities market such as the Primary Dealers, Value at Risk (VaR) models were introduced in December 2000. Initially introduced to measure market risk capital for regulatory purposes, the PDs are increasingly using VaR measures for their day-to-day risk management practices.

Improved risk management practices by financial institutions is the key to success in a competitive environment where new instruments such as Floating Rate Bonds, Derivatives etc are introduced in a gradual and progressive manner. Financial innovation provides opportunities and rewards to those with enterprise and vision. But at the same time, it exposes them to increased risks. Unless market participants institute sound risk management systems, holding trading positions tantamount expose them to severe risks. Indeed, risk taking and risk management must go hand in hand. The financial market needs players who are not afraid to take contrarian positions, who search for unoccupied habitats to provide diversity, provided they have adequate risk management systems in place. For market participants, there is little room for complacency and there appears to be no choice but to be pro-active in instituting appropriate risk management models. My view is that early adoption in this regard makes sound business sense and may prove immensely beneficial in a competitive financial sector.

Challenges to Financial Modelling

Let me add a few technical issues which are at the very core of an effective risk management system. While putting in place internal risk management models, particularly the Value at Risk models that are fast becoming industry standards, it is necessary to examine their relevance in the Indian financial markets that are characterized by fat tail behaviour. In this context, normal distribution based models may prove inadequate as they are prone to serious model risks. Historical simulation models that rely on full

valuations are free from model risks, but may face data constraints. In such situations, extreme value models and models based on Monte Carlo simulations can improve the accuracy of risk measurement. At the same time, attention needs to be paid to correlations amongst assets in diversified portfolio for purposes of risk aggregation. It is also necessary to conduct periodic scenario analysis and stress testing to supplement risk models.

Regulatory and Supervisory Initiatives

As the Indian financial system undergo structural changes relating to ownership, competition and integration with global financial markets, the necessity of an ongoing restructuring of the regulatory framework and improved monitoring of the embedded risks in the financial system was also recognized. The hallmark of Indian regulatory response has been its inclusive approach through a consultative framework, increased emphasis on self regulation and strengthening of market participants through measures of capital adequacy, corporate governance and effective internal control mechanisms. Increasingly, on-site supervision is being complemented by Risk based supervision. Presently, the RBS has been used in 23 Banks on a pilot basis, but one can certainly visualize the extensive use of RBS by regulators in India in the near future. In view of the complex nature of operation of financial conglomerates, the Reserve Bank of India is putting in place appropriate supervisory strategies. Regulatory initiatives also include consolidation of domestic banking sector; restructuring of Development Finance Institutions; and appropriate timing for the significant entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with our continuing obligation under the WTO commitments. In respect of foreign banks, regulatory initiatives are directed at: choice of the mode of presence, acceptable transition path, according national treatment, addressing supervisory concerns, linkages between foreign banks and their presence in other (non-banking) financial services.

Addressing Systemic Volatility

Another concern in financial market is the risks arising from market liquidity which may create adverse impact on volatility of interest rates. Since 2001, the Liquidity Adjustment Facility (LAF) has been instrumental in smoothening temporary liquidity mismatches while at the same time contributing to stability in short term rates within the repo-reverse repo corridor. The Reserve Bank of India has kept a close watch on the liquidity situation. Financial markets in India were characterized by ample liquidity in recent times, mainly due to persistent capital inflows. During 2004-05, liquidity absorption through Market Stabilization Scheme (MSS) was Rs.54,146 crore up to October 21, 2004. With the issuance of MSS, the repo volumes tendered under liquidity adjustment facility declined from an average of Rs.70,523 crore in April to Rs.13,805 crore in October 2004 (up to October 21). In addition to MSS and repo, surplus balances in the Central Government account with the Reserve Bank also helped in sterilizing excess liquidity from time to time. The Reserve Bank presently has sufficient flexibility in terms of instruments to contain market fluctuations through conduct of Open Market Operations(OMO). This apart, the Reserve Bank continues to monitor day-to-day liquidity through liquidity models and several measures of liquidity aggregates.

Improving Payment And Settlement Systems

Several efforts at reducing Settlement Risks have been undertaken in recent years. The payment system in India has been considerably strengthened in 2003-04 with the introduction of Real time Gross Settlement System (RTGS), the Special Electronics Funds Transfer System and the Online Tax Accounting System. Liquidity in the Government Securities Market was enhanced by the introduction of Delivery versus Payment (DvP III) mode from April,2004. Automated value-free transfer of securities between market participants and the CCIL was facilitated to further develop the collateralized borrowing and lending obligation (CBLO) segment. CCIL has also developed

the pricing and risk models for settling OTC derivatives, that is expected to be operationalised by March 2005. The national settlement system which would link up different clearing houses managed by RBI and other banks for centralized settlement is expected to be operationalised in early 2005. Appropriate risk mitigation mechanism for the retail payment systems is also under the active consideration of RBI and IBA. A Working Group under the Chairmanship of Dr. R.H. Patil reviewed the performance of NDS in the context of its operational efficiency and recommended an anonymous electronic screen based order matching trading system on the NDS. These measures are likely to reduce settlement risks while cutting down the costs of intermediation in the near future.

Finally, I would be failing in my duty if I am silent on **governance**. Governance issues in banks as also in capital markets have come to occupy centre-stage in recent times, in view of the irregularities involving accounting firms in the US and elsewhere. The quality of corporate governance becomes critical as competition intensifies, ownership is diversified and banks strive to retain their client base. You would be aware that the RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. Thus, the recommendations of the Consultative Group under the Chairmanship of Dr. A.S. Ganguly were forwarded to banks for implementation. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. Having said that, it is important to recognize that there is nothing like 'optimal' level of corporate governance. As banking business becomes more and more complex, banks should continuously strive to improve shareholder value through better governance practices.

In this context, governance issues in private banks have lately received a lot of attention, more so in view of the recent draft guidelines in this regard by the Reserve Bank. The intention of the draft policy has been to ensure adequate capital and consolidation in the banking industry with the regulator being aware of the intention of existing and potential shareholders. As announced in

the recent Mid-term Review, the RBI is consolidating the feedback received and after dialogues with various stakeholders, a draft policy framework has been finalised and would shortly be placed in public domain.

II. Capital Markets

Let us now turn to the issues faced by the Indian capital market in the era of globalisation. Among the emerging markets, India has one of the most vibrant capital market with the oldest stock exchange, highest number of listed companies, a wide geographical outreach, world class trading and settlement system, diverse range of product availability with a fast growing derivatives market, and well laid down corporate governance and investor protection mechanism. The Indian capital market is also evolving and adjusting with ease to the developments taking place internationally. Induced by the macroeconomic developments at home and positive growth outlook in several leading economies, the Indian stock markets touched dizzying heights during the last one and half years with the BSE Sensex driving past the 6000-mark. The momentum also got transmitted to the primary segment of the market with improvement in flow of resources to the corporate sector. The revival of the capital market was supported by higher flow of funds to the capital market, from institutional as well as retail investors.

Globalisation, in the orthodox sense, relates to integration of an economy or a market segment with the rest of the world. In this sense, globalisation of Indian capital market means, on the one hand, the ease with which Indian corporates can raise funds from the international markets and Indian investors can diversify their portfolios internationally, and on the other hand, the extent of freedom of the foreign corporates to raise funds from India and foreign investors to invest in India. India has made important strides in all these respects. While domestic companies were already permitted to raise capital in international markets, as a step towards opening the Indian markets to foreign companies, the Government recently permitted foreign companies to raise capital from Indian markets by way of issue of Indian Depository

Receipts. The scheme is likely to be implemented soon by SEBI. This would give an opportunity to local investors to invest and trade in internationally reputed companies that would be listed in domestic stock exchanges. The mutual funds and domestic investors have already been permitted to invest in securities listed abroad within stipulated limits.

Inter-linkages among financial markets

To my understanding, the first step towards globalisation is integration of various segments of the domestic financial markets. The dream of all central banks is to see the various segments of financial markets working in a smooth and well-coordinated manner. Well-developed financial markets help central banks to effectively conduct monetary policy with the use of market-based instruments. These markets also generate appropriate reference rates for pricing other financial assets. A necessary prerequisite for the smooth operation of the financial markets is the integration of domestic markets so that impulses can flow smoothly across different market segments and resource allocation process becomes more efficient. The inter-linkages between money market, government securities market and foreign exchange market are now fairly well established. However, as in financial markets in other developing economies, the capital markets in India are not yet fully integrated with the other segments of the markets. While the extent of integration between capital market and other segments of financial markets is much more deep in the developed economies, a consensus is yet to emerge on the role that equity prices should play in monetary policy formulation. This is more so because typically equity prices are more sensitive to “news” than to the underlying “fundamentals”. In India, there have been some episodes of volatility spillovers between markets in times of uncertainty. In view of the progressive integration of various segments of financial markets, the Reserve Bank keeps a close watch on activity in the equity market to guard against any possible spillover of disturbances to the money, the government securities and the foreign exchange

markets. In such situations, concerted policy response from the regulators can contain to a great extent the risks of transmission of volatility.

Improving Infrastructure of Capital markets

An interrelated and equally important issue is making the infrastructure for financial market – physical, institutional and legal – comparable with the best in the world. Adaptability of the capital market to the evolving needs of the various stakeholders and the contemporary changes elsewhere is yet another dimension of maturity and thereby the extent of globalisation of the capital market. In the capital market, the progress of reforms has been impressive during the nineties. However, certain refinements are needed to bring the Indian markets on par with the major international markets. To begin with, the domestic stock exchanges in keeping with the pace of reforms need to become corporate bodies and operate within a sound governance framework. The roles of the owners of stock exchanges, trading members and management need to be separated. The progress on this front has been somewhat slow. Another issue that needs to be addressed is the fate of regional stock exchanges, which are almost out of business. The consolidation of the regional stock exchanges in a single entity could be one solution. Other key issues that need to be addressed to aid the Indian capital market in becoming a global market relate to improvements in surveillance mechanisms, the creation of a central database of all market participants, electronic filing and maintenance of records, introduction of digital signature, and shortening of the settlement period to T+1. For improving financing mechanisms to support vibrant trading, the securities lending and borrowing and margin trading schemes need to be popularised and made more accessible. A healthy development in the markets in the recent upswing has been the coming into prominence of several mid-cap and small-cap companies. For the broad-based development of the capital markets, the regulatory framework has to emphasise more on issues relating to market integrity and safety and enforce strict action against fraudulent companies.

Corporate Governance

The issue of corporate governance has gathered tremendous prominence, especially in view of accounting irregularities in some of the leading companies in the US. With sound corporate governance practices emerging as an added factor in shaping companies' fortunes, more and more companies are waking up to merits of a well-governed corporate framework. The quality of corporate governance is going to become even more critical as the reach of globalisation widens and competition intensifies. An essential requirement for companies would be to undertake improvements in the areas of housekeeping, audit practices, constitution of the board and adopt strong internal controls. An interesting development in this area is rating of companies on the basis of adoption of corporate governance principles. The corporate governance codes for the listed companies in India have to evolve keeping in line with the standards being adopted internationally; these codes have to be enforced strictly with stringent punishment for companies failing to implement them.

Vulnerability of Indian markets

While talking about the capital markets, a closely related issue that I would like to highlight is the vulnerability or rather, stability of Indian equity markets. The positive domestic outlook coupled with relatively attractive valuations of the Indian market have attracted large investments from FIIs in the domestic capital markets. The FIIs were allowed to invest in the Indian capital markets in 1992. The interest of the FIIs in emerging economies including India has grown substantially over time. Except for a brief period in 1998-99, the FIIs have remained net investors in the Indian markets in all the years. The FIIs made net investments of close to Rs. 40,000 crore during 2003-04 in the Indian equity market, the highest investment by them in any single year so far. Though the pace of investment has slowed somewhat this year, FIIs have continued to retain their positions in the Indian markets. It is being felt in some circles that higher exposure of the Indian markets to foreign investors has made Indian markets vulnerable. I hold a different and more positive view on

this for various reasons- one, the volatility in Indian markets has consistently been much lower than in other emerging economies; two, the valuations of the Indian markets are still quite attractive as compared to other emerging economies; three, the confidence of the FIIs on the resilience of the Indian economy is quite evident from the fact after a brief pull-out by the FIIs in the month of May this year on account of several domestic and international factors, FIIs have continued to make handsome investments in the Indian equity markets. While admitting that FIIs do play an important role in shaping sentiments in the markets, my view is that, more often than not, FIIs have been instilling and boosting the level of confidence of market players.

Financing Corporate Sector

Let me now turn to the issue of financing growth and investment in India and I intend to speak on a wider plane here than just capital markets. But before going into the crux of issues here, let me briefly present the prevailing investment outlook for the Indian economy. The return to high growth in 2003-04 has brought with it renewed business optimism and a wider appreciation regarding India's potential for growth. The industrial climate during 2004-05 reflects a revival of investment demand and building up of capacity. Both the capital goods and intermediate goods sectors have recorded robust growth signifying the quickening of investment activity. This has been supported by improved corporate profitability, expansion in non-food credit and continuing optimism regarding production and export growth. Resurgence of investment demand and buoyant external demand are likely to be the main drivers of India's growth process during 2004-05.

A key issue in most fast growing economies is how to ensure adequate availability of finance to support investment and growth. Most countries rely on a combination of banking sector, other financial institutions and capital market for channelising funds to the corporate sector. Each country, however, has its unique set of dilemmas in their financial sectors. India is no different in

this respect. I would touch upon some key issues here, which are of particular relevance to India for the country to meet the challenges of globalisation.

Long-term Financing /Infrastructure Financing

Perhaps the biggest challenge in Indian financial sector at this juncture is to find sources for funding investments in long gestation projects including infrastructure. As in most other emerging market economies, corporate sector in India is often credit constrained. The shortage is particularly marked with respect to longer-term finance with the constraint being particularly severe for the small and medium-size firms. Traditionally, the development financial institutions (DFIs) were the major source of long-term finance in India. During the 1990s, the operative environment for the DFIs underwent a drastic change, which substantially altered their business profile. The balance sheets of DFIs became smaller with a continuous decline in their lending activities over the last few years. The DFIs found it difficult to raise funds at market rates and lend them in a profitable manner. The DFIs, therefore, were forced to follow the path of transformation. With two of the leading DFIs getting converted into banks, the financing of projects requiring lumpy investments with long gestation periods is not smooth as either other institutions do not have relevant skills for specialised project finance or their asset-liability profile does permit them to make large-scale foray in the area of project finance. In this context, there has been considerable debate in recent times on the role of banks in providing long-term finance. There is some case for allowing banks to raise funds from the debt market within some limits to enhance their capacity to invest in infrastructure projects. I would prefer a multi-agency approach for meeting these requirements as capacity to invest in longer-term assets is often limited.

Pension Reform

While sound institutional arrangements for tapping funds need to be developed, there is also a need to ensure adequate supply of these funds. The

development of the pension and insurance sector is an important area where reforms need to be implemented with vigor. Intensification of reforms in the areas of insurance and pension are essential not only from the angle of social security, but also for raising resources for long-term financing especially for infrastructure projects. The integral part of the process of evolution of the financial sector is the tapping of new savings to meet the surge in investment demand. Contractual savings that can be placed with the pension funds/insurance companies are the most natural source of funds that can be deployed productively in medium and long-term investments. At present, a large part of contractual savings is invested in the government securities. Backed by the rich experiences of other countries, there is a need for widening the investment avenues for pension funds and insurance companies after putting in place adequate prudential measures including a robust risk management framework. By doing this, it would be possible to exploit the emerging opportunities in both industrial and infrastructure financing. To tap further resources, institutional mechanisms also need to be put in place to draw the saving of the unorganised sector into formal channels.

Corporate Debt Market

The development of a deep and liquid corporate bond market is necessary for funding projects with long gestation lags and also for lending support to the process of asset securitisation. Typically, the corporate bond markets remain underdeveloped in most emerging economies. Despite long tradition, the corporate debt market in India is still in a nascent stage of development. The primary corporate debt market is largely of the private placement type and is concentrated among a few institutions both in terms of issuance and subscription. On the other hand, the secondary market for corporate debt is virtually absent in India. The stage for the development of a vibrant corporate debt market with a large issuer profile and investor base is now set with the successful development of the government securities and money markets. With the development of an active primary and secondary

market in government securities, a sovereign yield curve has emerged even for sufficiently longer-term securities. An efficient clearing and settlement system and credit rating system also exist. Some steps are still required to improve standards of public disclosure, implement bankruptcy laws and enhance supporting infrastructure. There is also need to broaden the institutional investor base, standardise products and reduce transaction costs.

Institutional Investment in Capital Market

While household financial savings continue to remain the major source of funds in the Indian financial system, there has been a shift in the willingness of the investors towards investing in safe instruments. A main reason for this was the high volatility of the stock markets in the latter half of the 1990s. Rather than investing directly in the stock markets, retail investors are preferring to route their investments through avenues such as mutual funds and insurance companies. The size of the mutual fund industry in India is, however, still quite small as compared to the developed countries. At present, the mutual funds in India are so far more active in the debt markets and less so in the equity markets. There have been some concerns in the past regarding skewed holding pattern of mutual fund schemes with dominance of few large investors, like corporates. It needs to be emphasised that the mutual funds essentially provide an avenue for investments to small investors who are not well-equipped to manage risks on their own. As this industry grows, the regulators would have to take steps to ensure that it develops on sound lines.

Venture Capital

For financing start-up firms, the role of venture capital can hardly be missed. The venture capital financing is especially important as they can focus on certain sunrise industries and also provide guidance to the start-up firms in the initial stages of their development. They play a very useful role in solving the problem of pre-IPO financing. The venture financing has not picked up that satisfactorily in India possibly because of stringent regulations. Several issues

relating to lock-in of shares, exit options, freedom to invest in various types of instruments, modes of investment and some tax-related issues need to be addressed to encourage flow of venture capital funds in India.

III. External Sector

Liberalisation in the 1990s: Pace and Content

The decades of the 1980s and the 1990s have witnessed a shift in policy stance towards openness among a number of emerging market economies (EMEs) - either spontaneously to benefit from greater volumes of trade and external investment or under the compulsions arising out of unsustainable domestic imbalances. With the increasing participation of foreign investors and institutions in the financial markets of developing countries, the capital account has been the focus of attention particularly in the 1990s. Expansion of capital flows has been much larger than that of international trade flows. The process has been reinforced by the ongoing abolition of impediments and capital controls and the widespread liberalisation of financial markets in developing countries during the 1990s. A distinguishing feature is that private flows, as opposed to official flows, have become a dominant source of financing. Second, there has been a shift away from debt flows towards equity flows, especially direct investment. FDI has been the dominant source of private external financing for EMEs and has proved to be relatively stable even during the crisis years. Unlike the FDI, swing in bank lending has been pronounced between the crisis and non-crisis countries in the late 1990s. In fact, FDI flows FDI inflows mitigated the adverse impact of debt outflows on the financial markets of such countries.

In India, liberalisation of external sector during the 1990s consisted progressive dismantling of trade restrictions, current account convertibility, shift to market determined exchange rates and gradual liberalisation of capital account. The increasing openness of the Indian economy is mirrored in rising share of current receipts in GDP, a floating exchange rate, transmission of global financial market developments on the exchange market, swift foreign

portfolio rebalancing by domestic banks in response to global developments, accessing international markets by domestic corporates at competitive rates, greater investor interest in the form of FDI and FPI flows and increased synchronicity of domestic activities with global business cycles. A key aspect of the external sector liberalization has been trade reforms with accent on reduction in import tariffs. The “peak” rate has been progressively brought down from 150 per cent in 1991-92 to 25 per cent in 2003-04. Since January 2004, the peak rate of customs duty on non-agricultural goods has been further reduced to 20 per cent in tandem with the goal of bringing down tariff rates to competitive level of East Asian economies over the medium-term. Opening up of the financial sector in terms of entry of foreign entities and easing of restrictions on international transactions took place within the broader process of reforms. The constant policy concern in this respect has been that of preparing the financial sector for global competition and taking preventive measures for the potential vulnerabilities that it might engender. The Indian rupee for all practical purposes has been made convertible for foreign investors, however, restrictions on capital outflows involving residents continue as a part of prudent approach to capital account.

Globalisation - India's External Sector Gathering Greater Resilience

Responding to the increasing financial globalisation, the external sector has exhibited greater resilience to cushion domestic activity against external and internal shocks. The run of current account surpluses that began in 2001-02 extended into the first quarter of 2004-05 – a steady rise from 0.2 per cent GDP in 2001-02 to 1.7 per cent in 2003-04. Reflecting the rising technology and knowledge content in the output of industry and services, the exports of manufactured goods as also travel-related and private business services grew robustly. Services exports witnessed sustained buoyancy reaching US \$ 25 billion in 2003-04. Software exports remained resilient and vigorous in the face of the IT slowdown worldwide and a protectionist reaction against outsourcing in some industrial countries. Remittances from Indians abroad continued to be

a key component of India's balance of payments. The role of invisible earnings in underpinning the strength of the current account is perhaps the most noteworthy feature of balance of payments developments since the 1990s, as they enabled meeting a sizeable expansion in import demand without recourse to additional external liabilities.

Sustained investor optimism about the resurgence of growth in India brought in massive capital inflows reaching US \$ 31 billion in 2003-04, leading to an unprecedented accretion to the foreign exchange reserves. The foreign exchange reserves rose to US \$ 113 billion by end-March 2004 and further to US\$ 121 billion as on October 22, 2004. By March 2004, India had accumulated the sixth largest stock of international reserves, sufficient to finance 17 months of imports and over five years of debt servicing. The level of reserves exceeded the level of external debt by the end of March 2004. Indicators of external debt sustainability such as debt to GDP and debt service ratios continued to record a healthy improvement. The burgeoning reserves enabled a further consolidation of external debt during this period through prepayment of multilateral and commercial debt as well as shifts in the composition and maturity of non-resident deposit liabilities.

Strategic shifts in the policy stance during 2002-03 and 2003-04 were also reflected in significant liberalisation of the exchange and payments system extended to freeing outward capital flows, fine tuning of interest rates on non-resident deposits to align them more closely with international interest rates and a tighter linkage between funds raised abroad and end-use domestically. There was also an upgradation of the sovereign rating to investment grade during 2003-04 for the first time since 1997-98. These developments, coupled with the rising surplus in the current account, facilitated a step-up in the pace and spread of the liberalisation of the exchange regime.

Issues in Perspective

Greater globalisation of the financial system has certainly entailed gains for the external sector; it has also created certain challenges for policy makers.

The issues that need attention in the backdrop of greater global integration and external sector liberalisation are as follows.

- The growing strength of India's external sector has provided the enabling conditions to accelerate the pace of external liberalisation. Liberalisation of foreign exchange transactions has to be backed up by **price alignments in the form of reduction in tariff rates**. The experience of most emerging markets suggests that internationally competitive tariff rates contribute towards export performance on a sustained basis.
- The ongoing process of capital account liberalisation would deepen the foreign exchange market and make cross-border transactions increasingly sensitive to movements in interest rates and exchange rates. **Capital account liberalisation is a process which has to be managed keeping in view the supply response of the economy and vulnerabilities or potential for shocks**. Markets tend to react asymmetrically with a strong negative bias to reversals, unless there is already a crisis situation. The process of capital account liberalisation has to take into account the revealed preference for hierarchy in different types of capital flows.
- A key issue in managing the capital account is **credibility of policies and the building up of safety nets** to provide comfort to the markets. This also underscores the importance of prudential regulations over financial intermediaries in respect of their foreign exchange exposures and transactions, which are quite distinct from capital controls. It is the changing mix of controls that characterises the process of managing the liberalisation of the capital account.
- As liberalisation advances, the administrative measures would get reduced and **price-based measures would be relied upon increasingly**, but the freedom to change the mix should always be demonstrably available to assuage market sentiments in times of stress.
- **Outward** FDI is receiving increased policy attention, not merely as a means of contending with capital inflows but also as a growing expression of competitiveness and entrepreneurial energy of Indian industry. FDI may

be for resource-seeking, market-seeking, acquiring domain-knowledge or for business synergies. A greater integration with the global economy would be fostered and resilience imparted when India not only receives FDI but also promotes outward FDI.

FDI: Needs to Catch up!

- The bulk of FDI was channelised into services, computers (hardware and software) and engineering industries. The sectoral pattern of FDI inflows to India shows that despite a slowdown in the overall level of FDI, flows into the engineering sector have remained stable, largely in consonance with buoyancy in export growth in that sector. Export promotion policy needs to utilise the natural complementarity of Foreign Direct Investment (FDI) with export activity. In order to carry forward the process of liberalisation of the external sector, the Union Budget for 2004-05 proposed to raise the sectoral caps for FDI in telecommunications (from 49 per cent to 74 per cent), civil aviation (from 40 per cent to 49 per cent) and insurance (from 26 per cent to 49 per cent). Also, Union Budget 2004-05 made the procedures for registration and operations simpler and quicker for FIIs. It also raised the investment ceiling for FIIs in debt funds from US \$ 1 billion to US \$ 1.75 billion.
- Despite substantive reforms and liberalisation of external sector remain resulting in increase several administrative and procedural hurdles. The time lag involved in converting investment intentions to actual flows of foreign exchange, technology and know-how compared with investment destinations which have proven attractiveness on account of the ease in investing. The global reach and marketing abilities of FDI could be effectively utilised to provide a cutting edge to the export effort. The thrust on attracting higher FDI inflows in infrastructure sector should be dovetailed into the regulatory and pricing reforms in major infrastructure services such as power and transportation.

Software Exports and BPO: Emerging Driver of Services Exports

- The renewed buoyancy in services exports has, to a great extent, dispelled the gloom associated with the inability to expand India's share in world merchandise exports even to the 1950s level of one per cent.
- Exports of software and IT-enabled services has been growing at an average rate of 46 per cent since the mid-1990s reaching US \$ 12.2 billion in 2003-04. With the global IT market focussing on maximisation of return on investment and reduction of costs, there has been an increasing trend towards outsourcing to low cost offshore centres. India is a leading destination for outsourcing of Information Technology Enabled Services (ITES) and other related BPO activities. Currently, India renders more than two-thirds of all offshored ITES worldwide encompassing not only ITES but a wide range comprising services relating to manufacturing, banking, insurance, sales, marketing, utilities and human resources. India's comparative advantage in the outsourcing business is on account of availability of well developed telecommunication network and advanced technological infrastructure, skilled yet low cost labour force, widespread use of English language, and India's location in a different time zone from the United States (US) enabling a 24-hour service.
- The outsourcing has reduced the prices of IT hardware by 10-30 per cent due to the diffusion of IT throughout the US economy. The US outsourcing from India reduces costs by 40-60 per cent, improves quality by 3-8 per cent and increases productivity by 20-150 per cent. A number of US companies are in favour of outsourcing to India purely on economic grounds. Certain industrial countries have, however, begun to view the outsourcing of ITES-BPO as a loss of domestic employment. Several States of the US have introduced legislations seeking a ban on outsourcing of various economic activities from India. A study by Global Insight reveals that the majority of job losses to offshore outsourcing between 2000-03 occurred due to factors such as the slowdown in the US and the bursting of the telecom and dotcom bubbles.

- To meet these challenges Indian entities should diversify their markets and continuously innovate and maintain its low-cost niche in order to compete with competitors like the Philippines, Malaysia, Australia, South Africa, and Singapore. India needs to set up more foreign affiliates in the IT segment to provide services offshore, besides attracting more FDI to undertake BPO activities in the country, which would pacify the protectionist reactions.
- The Indian BPO industry should strive to achieve cost efficiency and competitive price advantages through mergers and acquisitions in India and abroad to withstand the competitive threat, particularly from the emerging East Asian countries.

Workers' Remittances – Stable Source of External Finance

- The surge in workers' remittances to India during the decades of the 1970s through the 1990s has resulted in India becoming the highest remittance receiving country in the world. Migrant workers' remittances to India touched an all time high of US \$ 23.2 billion in 2003-04. These are found to be counter-cyclical and as such they have provided some element of stability to the current account balance of recipient countries. India's overwhelming comparative advantage reflects the vast pool of skilled and semi-skilled labour and technical manpower in the country and the ability to successfully locate labour overseas. Workers' remittances are above 3.5 per cent of India's GDP and have provided considerable support to India's balance of payments. These have exhibited the lowest volatility among all categories of current receipts, after merchandise exports. Unlike the capital flows, interest rate differentials are not found to be significant in determining workers remittances, underlining the stable nature of these flows.
- Presently, the complex immigration policies in developed countries poses hurdles for movement of workers. Mobility of temporary workers may rise

depending on the progress under GATS under Mode 4 of supply of services.

- Due to aging of population and rising pension liabilities in the developed world, the trend towards migration of skilled workers may accelerate in the future. However, an additional factor determining the demand for overseas workers and the remittance flows to developing countries would be sustained growth in developed countries.
- Workers' remittances like other future flow receivables i.e., oil exports, credit card receivables, have the potential of securitisation.
- High transaction cost of remitting funds has been an important challenge. Improved banking/delivery network and cooperation between the source and the destination countries may help in bringing down such costs.
- Greater Resilience Reinforces Capital Account Liberalisation
- The process of liberalisation of the capital account was accelerated during 2003-04 with an accent on facilitating outflows by residents. Resident individuals were permitted to remit an amount of up to US \$ 25,000 per calendar year for any current and capital account transaction and to borrow up to US \$ 2,50,000 or equivalent from close relatives residing outside India free of interest with a minimum maturity of one year.
- Authorised dealers were permitted to allow remittances up to US \$ one million per calendar year, out of balances held in Non-Resident Ordinary (NRO) accounts/sale proceeds of assets, subject to the payment of applicable taxes.
- Norms for external commercial borrowings (ECBs) were further liberalised in respect of eligibility, end-use restrictions and spreads. The limit for the automatic route was raised to US \$ 500 million and the approval process in respect of loans above US \$ 500 million was shifted from the Government to RBI.
- Resident corporates were allowed to raise ECBs for overseas direct investment in JV/WOS.

- FDI in private sector banks raised from 49 to 74 per cent of their paid up capital under the automatic route. In case of public sector banks FDI and FPI are allowed up to 20 per cent.
- FIIs and NRIs were permitted to trade in exchange traded derivative contracts.

Let me conclude. I have touched upon certain issues which, from the viewpoint of a central banker, are critical for banks to become globally competitive. Needless to state, I might have, in the process, bypassed certain operational details which I believe, my fellow speakers would dwell upon during the course of the Conference.

The Indian financial sector has taken several steps in the right direction, but much more needs to be done. The effort certainly needs to be undertaken through continuous consultative process between the regulators and market participants. A cautious approach towards increasing efficiency within the framework of overall financial stability can significantly contribute towards India becoming a leading financial force in the world. At the present juncture of Indian financial market, participants can reap huge benefits from enterprise, innovation and vision. In the current scenario, banks are constantly pushing the frontiers of risk management. Compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders are inducing banks to look at newer avenues to augment revenues, while trimming costs. If Indian banks are to become the global leaders of tomorrow, the time is opportune for them to march forward. My best wishes are with them.

Once again, let me thank the organisers for inviting me to this Conference and the audience for their kind and patient hearing.

Thank you.