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Banking Sector and Liberalization in India

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ABSTRACT

The Indian financial system is going through major changes as we know bulk of changes have been carried out by our government such as Jan Dhan Yojna, Digital India, Demonetization, ceiling on cash transactions, etc. The future can be analyzed by the history and basic nature of the economy and the banking sector has been stagnant. Various reforms have been rolled out regarding the banking sector since the early nineties. Allowing foreign banks, deregulation of interest rates, decreasing bank rates and SLRs, etc. are some crucial steps to impart functional autonomy and efficiency in Indian banking to make the sector competitive. After almost three decades it is crucial to analyze the how banking sector is performing after the reforms and how it is impacting on the economy. The present paper will throw light on trends of the real rate of interest, investment, credit growth, and working of money multiplier. Banking habits of people are still not much modernized and the use of currency is higher in the economy.

Keywords: Banking sector, banking habits, credit growth, NPAs and investment.

INTRODUCTION

Indeed, the relationship between financial liberalization and its impact on the economy is a subject of considerable interest and debate among economists and policymakers. Financial liberalization typically involves removing restrictions on financial institutions and markets, allowing for greater flexibility and efficiency in the allocation of capital. One key aspect of financial liberalization is the promotion of credit creation and ensuring the availability of funds in the economy.

The liberalization of the financial sector in India, as recommended by the Narasimham Committee, has been a crucial component of the broader economic reforms initiated in the early 1990s. The liberalization measures aimed at transforming the financial landscape of the country to promote economic growth with also the stability.

The liberalization was also seen as a means to provide the necessary financial support for various sectors like agriculture, industry, and trade. By removing restrictions and promoting efficiency in the financial system, the intent was to encourage investment, entrepreneurship, and overall economic growth.

The Narasimham Committee, in its various reports, laid out a roadmap for financial sector reforms. The recommendations included measures to improve the efficiency of whole financial structure, strengthen the banking sector, and enhance the overall health of the financial system.

Liberalization aimed at increasing the availability of credit by allowing banks to operate more freely, encouraging competition, and reducing government control. This was expected to benefit sectors that required substantial capital for development. In addition to promoting growth, liberalization of the financial sector was also seen as a measure to ensure the stabilization of the economy. By introducing reforms in areas such as fiscal discipline, monetary policy, and exchange rate management, policymakers sought to create a more stable economic environment.

Financial liberalization also involved integrating the Indian financial markets with global markets. This integration was expected to bring in foreign capital, technology, and best practices, contributing to the development and modernization of the financial system of India, and the liberalization of the financial institutes has brought about favorable effects and positive changes, it has also faced challenges and criticisms. Issues such as non-performing assets (NPAs), financial inclusion, and the impact on vulnerable sections of society have been areas of concern that policymakers have had to address.

The liberalization of the Indian financial sector, as recommended by the Narasimham Committee, encompassed a comprehensive set of measures aimed at unlocking the potential for economic growth. This involved not only the relaxation of controls, including lowering Cash Reserve Ratio (CRR), bank rates, and Statutory Liquidity Ratio (SLR), but also a deliberate effort to enhance efficiency, productivity, and profitability through increased competition within the banking sector. The removal of restrictions sought to create a more dynamic environment, prompting financial institutions to innovate and operate more effectively. Important macroeconomic indicators, such as credit creation, the rate of investment, and interest rates, came under the purview of these reforms. The liberalization agenda was strategically aligned with the imperative of boosting credit availability, influencing interest rates to stimulate borrowing and investment, and ultimately fostering a higher rate of investment

across various sectors. Monitoring these variables became crucial for policymakers, providing insights into the health of the financial structure also affecting overall economic growth trajectory. While liberalization brought about positive changes, ongoing assessment and adjustments were required to navigate the complex and evolving dynamics of a liberalized financial landscape.

REVIEW OF LITERATURE

Das and Goyal (2001) conducted a comprehensive analysis of the money supply process in India, emphasizing challenges in its estimation. The money multiplier, influenced by currency and demand deposits (C\D) as well as required and excess/borrowed reserves (R\D), holds significant importance. Household decisions on C\D hinge on income, time deposit interest rates, expected inflation, and other time-sensitive factors. Banks' choices for R\D involve a mix of required and excess/borrowed reserves. In a setting of fixed nominal interest rates, shifts in asset prices and inflation bear considerable opportunity costs. However, in a nation with fluctuating interest rates, the interrelationship among various rates presents a substantial challenge for estimation. To address this, Das and Goyal proposed a method to estimate M3-H (broad money minus high-powered money) based on output, price, and interest rate variables. This approach captures the collective impact of credit response to structural price indicators, serving as proxies for interest rates and uncovering deeper determinants frequently used in elements of the money multiplier. The model aims to resolve identification issues and provide a nuanced comprehension of the factors influencing the money supply process, especially in the context of India's variable interest rates.

Saggar (2003) conducted the research with focus on the trends in saving, investment, and economic growth, exploring the interrelationships between these factors and comparing the pre-reform and post-reform eras. Notably, he observed a significant increase in private corporate fixed investment during the reform year, accompanied by a decline in inventory rates. Over the initial five years of reforms until 1995-96, private sector investment exhibited an overall upward trajectory, reaching its pinnacle at 9.6 percent of GDP. However, in the subsequent years, there was a decline, ultimately settling at 5.9 percent of GDP in 2000-01. Though it was decreasing , the investment rate in the sector remained notably higher than in the pre-reform years. Saggar's findings shed light on the dynamic shifts in private sector investment patterns following economic reforms.

Bhattacharya and Chakravarty (1995) conducted a study spanning from 1950-51 to 1990-91, employing an alternative Bayesian methodology developed by Spiegel Halter and Smith (1982) to test the monetary model of inflation. The study encompassed both narrow and broad money, utilizing Ordinary Least Squares (OLS) estimates to scrutinize the assertion that 'inflation is a monetary phenomenon.' To delve into the impact of bank nationalization on India's monetary policy, the research divided the entire period into two segments: 1950-51 to 1969-70 and 1969-70 to 1990-91. This segmentation aimed to explore how the sample period choice affected the study's outcomes. The OLS estimates indicated that, within a static framework, the monetarist model had limited sway over inflation in India. However, in a dynamic model, monetary variables accounted for slightly over 50 percent of the fluctuation in the inflation rate. Furthermore, employing a Bayesian model unveiled a dynamic correlation between money and prices in India. Ultimately, the study dismissed the pure theoretical monetarist model of inflation, attributing its invalidity to the presence and impact of the 'anti-monetarist' model.

Mujumdar (2003) conducted an assessment of financial sector reforms, outlining three paradoxes that underscored certain challenges within the system. The first paradox highlighted the high liquidity of the banking system, leading to an unexpected situation where banks, due to excess liquidity, were primarily pursuing prime borrowers in the corporate sector. The second paradox drew attention to a notable decrease in the proportion of total credit allocated to priority sectors despite financial reforms. The third paradox centered on the Reserve Bank of India's (RBI) explicit aim to reduce the Statutory Liquidity Ratio (SLR) to 25 percent, contrasted with banks' voluntary investment of a substantial portion of resources in government securities. This accumulation of surplus securities was portrayed as a symbol of inefficient banking directly linked to the reform package. The result was the redirection of bank resources away from the productive sector, funneling them instead into government securities and inadvertently fostering government consumption. Mujumdar's analysis brought these paradoxes to the forefront, emphasizing the intricacies and unintended consequences of financial sector reforms.

Jha and Rath (2003) delved into the intricacies of the endogeneity of the money multiplier in India, shedding light on its variations resulting from financial reforms. During the 1990s, the money multiplier exhibited an increase, rising from 3.10 in the 1980s to 3.27. This era witnessed substantial capital inflows due to reforms. The introduction of open entry for banks and financial institutions into financial markets generated competitive pressures, stimulating innovation in product design. Notable examples included advancements in savings deposit withdrawals, the integration of features from current and savings accounts in automatic transfer facilities, and the emergence of automatic teller machines. These financial innovations increased the liquidity of deposits, augmenting their transactional functionality.

Consequently, financial innovation was identified as a factor contributing to the rise of the money multiplier

and a simultaneous decrease in the velocity of circulation. Furthermore, Jha and Rath delved into the impact of interest rate changes on the substitution pattern among monetary assets. Swift adjustments of deposit rates maintained opportunity costs, asset holdings, and the multiplier, while slower adjustments affected opportunity costs, prompting portfolio adjustments that influenced the multipliers. Real income growth was recognized as a driver for an increased demand for monetary assets, with asset-holding ratios, such as the currency ratio, contingent on income and payment systems. The role of the yield spread was also emphasized, with the steepness of the yield curve serving as a reliable indicator of asset shifts across or outside the money aggregates. The study thus shed light on the dynamic interplay of financial reforms, innovation, and various economic factors in shaping the endogeneity of the money multiplier in the Indian context during the specified period.

The money multiplier is defined by two crucial behavioral parameters: the currency-deposit ratio and the reserve-deposit ratio. Within the sphere of reserves, there are two categories: required reserves and excess reserves. Banks may choose to maintain excess reserves beyond the mandated level to accommodate unforeseen demands for cash payments to other banks. Despite not yielding interest, these excess reserves come at a cost to banks. The money supply, in turn, is directly proportional to the high-powered base and inversely related to both the reserve-deposit ratio determined by banks and the currency-deposit ratio chosen by the public.

In the short run, monetary movements triggered by changes in the money multiplier take precedence, making precise control by the central bank challenging. However, over an extended period, high-powered money assumes greater significance. This distinction underscores the complexities of monetary dynamics, where short-term fluctuations driven by the money multiplier give way to the enduring influence of high-powered money on the broader monetary system.

Trends in investment

The transformation of the banking system from a heavily regulated interest rate regime to a market-related one stands as a significant achievement, deserving commendation for the Reserve Bank of India (RBI). Dr. Rangarajan, the Governor of RBI, marked a pivotal moment in monetary history by abolishing the prescribed minimum rate for large borrowers on October 8, 1994. This move was anticipated to stimulate economic investment by reducing lending rates. Although lending rates did exhibit a decline post-1995-96, the anticipated boost in investment did not materialize due to the contrary behavior of real lending rates. Despite the decreasing trend in lending rates, investment followed an increasing trajectory in real interest rates, deviating from the nominal rate during 1999-2000 when it continuously rose until the onset of the 2007-08 recession. Interestingly, investment, except in some cases in the early reform era, did not consistently align with any specific interest rate. Even during 2010-11, when faced with a negative real interest rate, investment failed to respond positively, underscoring the complexity of factors influencing investment decisions in the evolving economic landscape.

Nominal & Real lending Rates

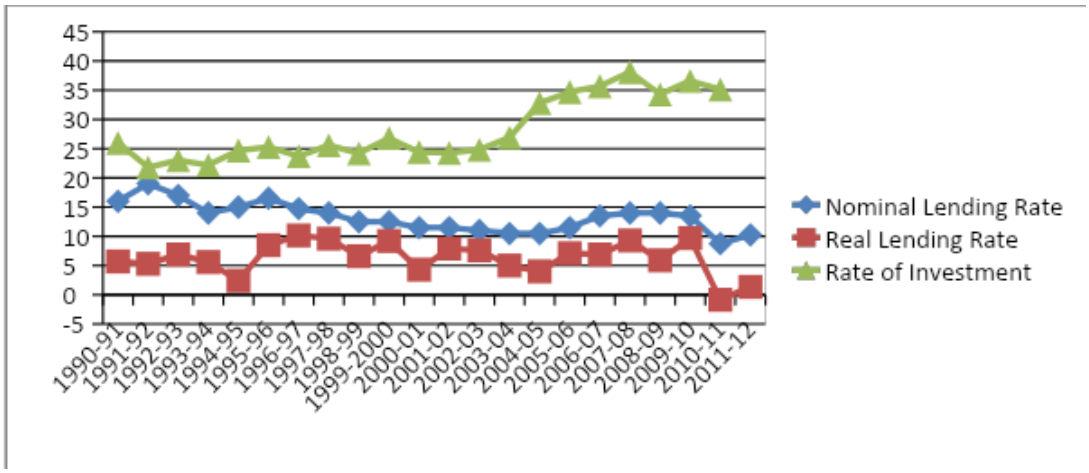


Figure -1: Rate of Investment, Nominal & Real Lending Rates

The deregulation of lending rates for large borrowers had repercussions, leading to unhealthy competition among banks. This manifested in a scenario where banks were willing to offer loans to multinational corporations (MNCs) at a 9% rate of interest, while simultaneously expecting higher rates, such as 12%, from economically disadvantaged farmers. This disparity in lending rates reflected a significant challenge in the financial sector.

Furthermore, a substantial portion of banks' liquidity was redirected towards the government due to the high yields on government securities. This shift had

implications for the allocation of resources within the banking system, raising questions about the efficiency and equitable distribution of funds.

Despite the inconsistencies among policies, the Indian financial system has demonstrated resilience and strength. It has managed to navigate through the complexities arising from both sound and flawed policies. The system's ability to function effectively within the context of a globally integrated economy speaks to its adaptability and robustness. The recognition of the financial system as strong, despite the challenges posed by inconsistent policies, highlights its capacity to absorb and adjust to various economic conditions, contributing to its overall stability.

Growth of Credit

Money supply was expected to increase to provide lubrication to growth of the economy. Various monetary measures were adopted to make banks more competitive as foreign banks were also allowed in India. Banks are money creators and business activities need enough liquidity. Narrow money which reflects the purchasing power is analyzed in the present study. There is a deep decline in money supply during the crises (Figure - 3). Growth of credit creation also exhibited a sudden decline (Figure - 4). After the recovery, the same is happening during 1995-96 and 1996-97 again.

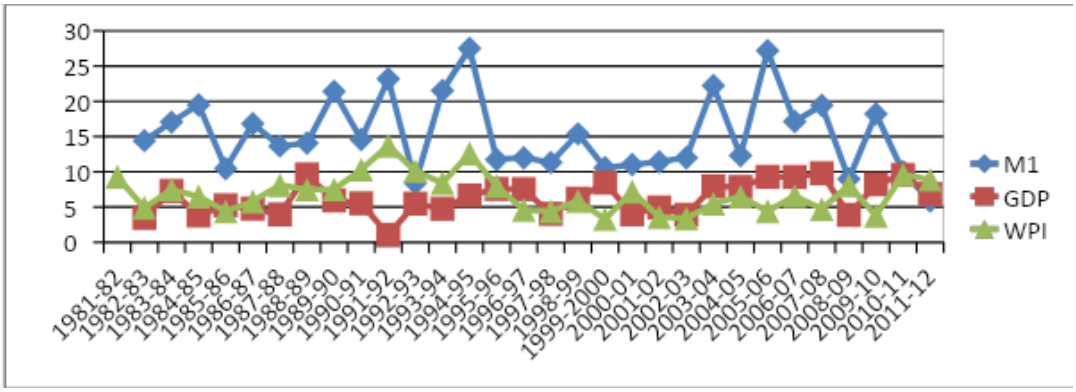


Figure- 2: Growth of M1, GDP and WPI

Banks create money through credit creation, A cheap monetary policy was adopted during the post-reform era, but there is no clear effect on the growth of credit seen. It was expected to increase at an increasing rate but many times it had been declining in the post-reform era. The ratio of credit to total deposits has been decreasing except for some fluctuations. Deregulation of interest rates and cheap monetary policy could not support the growth of credit.

If we compare the credit to the commercial sector and government sector, the growth of credit to the government has been relatively higher many times.

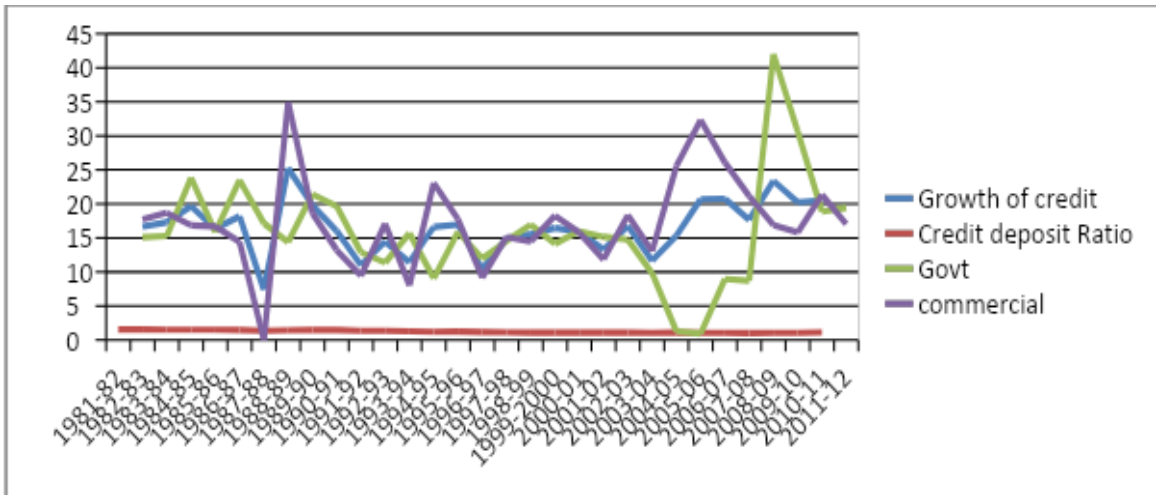


Figure- 3: Growth of Credit, C/D Ratio. Credit to Govt. and Commercial Sector

Investing in Government Securities has historically been regarded as a secure option for banks due to the minimal risk associated with these instruments. The relationship between risk and return in securities is well-established, with risk typically being positively correlated with returns. While there are alternative

investment options that offer higher returns, banks must carefully balance the pursuit of returns with the imperative of maintaining solvency, especially when dealing with excess reserves.

Traditionally, banks prioritized solvency and opted for Government Securities even if the returns were relatively low. However, the landscape has evolved in the post-liberalization era, transforming Government Securities into an attractive option with both high returns and a high level of safety.

The debate among monetarists regarding the very high yield on Government Securities has been ongoing. The interesting dynamic emerged as bank rates decreased while the yield on Government Securities increased. In the post-reforms period, there were instances when the yield on Government Securities exceeded the bank rate. This created a situation where banks could borrow from the Reserve Bank of India (RBI) at lower rates and invest in Government Securities at higher yields, resulting in a seemingly painless gain without much effort.

Examining the ratio of investment in Government Securities to aggregate deposits reveals an upward trend during the post-reforms period. A noteworthy consequence of the increasing yield on Government Securities was a continued high level of investment in these securities, even after a reduction in the statutory liquidity ratio (SLR). Despite the SLR being set at 25% since September 1993, banks demonstrated an incremental investment in Government securities as high as 33.3% in the fiscal year 1993-94, as noted by N.A. Mujumdar. This highlights the strategic shift in banks' investment behavior in response to changing yields on Government Securities.

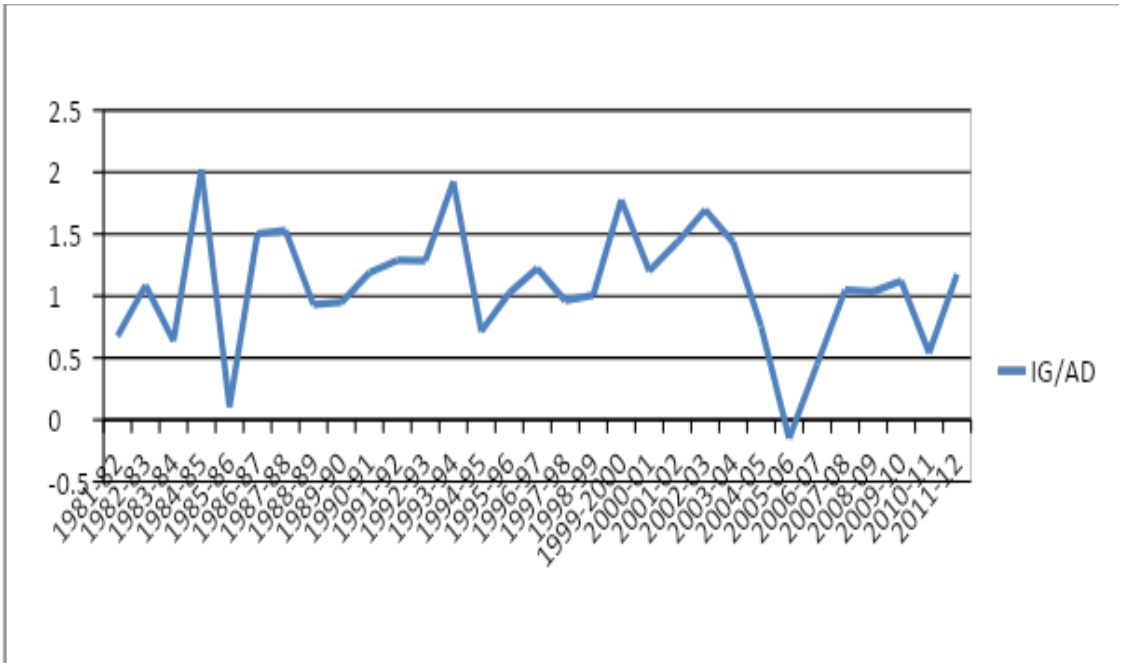


Figure- 4: Investment in Govt. Security/ Aggregate Deposits

Indeed, the observed low growth rate of credit can be attributed to the increasing trend of investment by banks in Government Securities. As mentioned earlier, the shift in banks' investment behavior, particularly towards Government Securities, has been notable, especially in the post-liberalization period.

The attractiveness of Government Securities, offering a combination of high returns and a high level of safety, has led to a significant allocation of funds in this direction.

Banks opting for the relatively secure investment avenue of Government Securities might have diverted a substantial portion of their resources away from lending to other sectors of the economy.

This reallocation could contribute to the observed low growth rate of credit, as funds that could have been channeled into credit for private enterprises or individuals were instead invested in Government Securities.

The implications of this trend underscore the interconnectedness of different components within the financial system and how the choices made by financial institutions, influenced by factors such as yields and perceived risks, can impact the broader economic landscape, including credit growth. The balance between safety and returns plays a crucial role in shaping the investment decisions of banks and, consequently, the overall credit dynamics in the economy. There is a factor of indignity in credit as its supply will be created on its demand immediately by banks. Declining growth of credit and increasing reserves and surpluses with banks also reflect the low demand for credit.

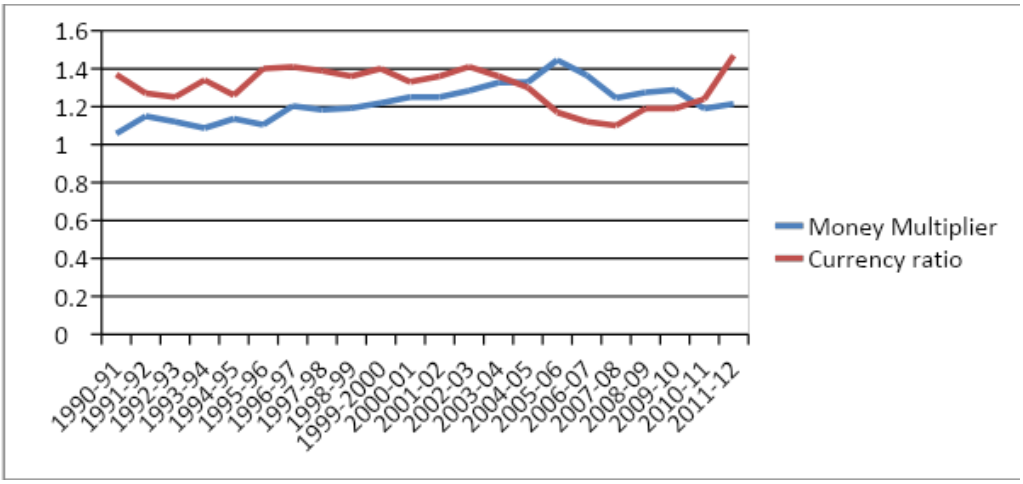


Figure: 5

Figure-5 illustrates the relationship between the money multiplier and the currency ratio. The money multiplier's value undergoes fluctuations in response to changes in the currency ratio, which represents the ratio of currency held by the non-bank public to demand deposits with banks. This ratio is primarily determined by the decisions and behaviors of the non-bank public. Notably, there exists a negative correlation between the currency ratio and the value of the money multiplier. When the currency ratio rises, the value of the money multiplier decreases, and conversely, when the currency ratio falls, the value of the money multiplier increases.

A high currency ratio signifies that a significant portion of reserve money is held by the non-bank public rather than being deposited with banks. This allocation has implications for the ability of banks to create credit. Factors influencing the currency ratio include the terms under which banks accept deposits and prevailing banking habits among the public.
Figure-5 highlights the dynamic interplay between the money multiplier and the currency ratio, emphasizing the crucial role of the non-bank public's decisions in influencing the distribution of reserve money and, consequently, the ability of banks to engage in credit creation.

$$\text{Currency ratio (c)} = C/DD$$

Here the money multiplier is also the ratio of money supply (M1) to reserve money. We can see some fluctuations in the money supply in the very starting but after 1996-97 there is a continuous increase in the money multiplier, but after 2005-06 it declines.

The currency ratio serves as a reflection of the prevailing banking habits within the economy, where a higher use of physical currency suggests less developed banking habits among the populace. Despite a significant increase in the number of banks following liberalization, the currency ratio has remained high, indicating persistent reliance on physical currency. Although there was a decreasing trend in the currency ratio from 2001 to 2008, it remained above unity, and subsequently, it began to increase once again.

Even with the proliferation of banks in the post-liberalization era, the Census of 2001 revealed that the ratio of demand deposit accounts to the total adult population was only 59% as of March 31, 2004, underscoring the need for broader coverage of banking services. Notably, India boasts a considerable number of ATMs, totaling 74,505, with 66.42% owned by the public sector and 31.74% by private sector banks.

Furthermore, the issuance of 227 million debit cards signifies a substantial presence in electronic transactions. However, despite these advancements, the banking sector in India faces both challenges and opportunities, signifying a journey ahead that necessitates addressing hurdles while capitalizing on potential growth avenues.

Trends of NPAs

Non-Performing Assets (NPAs) can be defined as loans or advances where the payment of interest or the repayment of principal, especially in the case of term loans, remains overdue for a specified period. The definition of NPAs in India has evolved over time. According to the Narasimham Committee Report in 1991, assets including advances, overdrafts, bills discounted, and cash credit, where interest remains unpaid for four quarters or 180 days, were categorized as NPAs. Subsequently, from March 1995, this period was reduced to 90 days, indicating a more stringent classification.

To address the issue of NPAs, various measures were implemented based on the recommendations of committees such as Tiwari and Narasimham. Debt Recovery Tribunals were established across the country, and an Asset Reconstruction Company was formed. Additional strategies to mitigate NPAs included corporate debt restructuring, rescheduling and

restructuring of banks, and recovery initiatives through Lok Adalats, Civil Courts, Debt Recovery Tribunals, and compromise settlements. Legal reforms were introduced to expedite the recovery process, reflecting a multifaceted approach to managing and reducing NPAs in the Indian banking sector.

Non Performing Assets of Banks

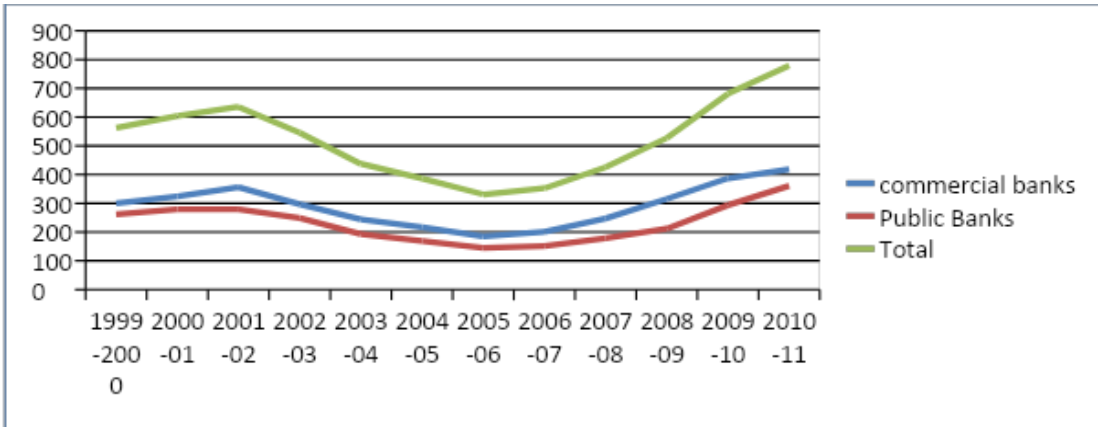
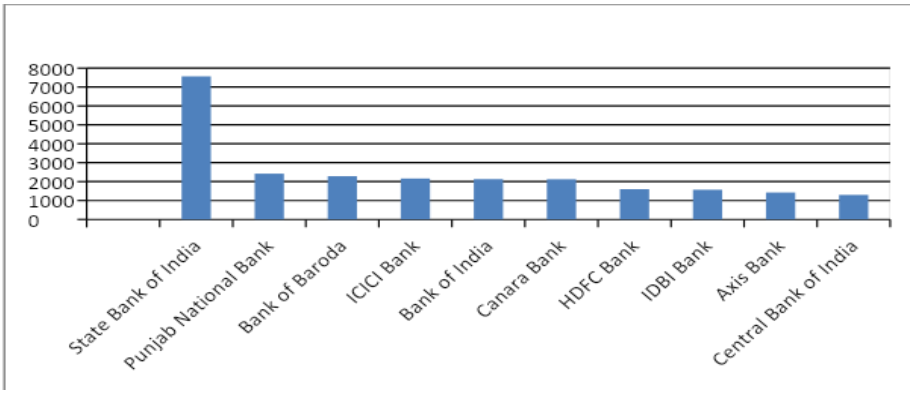
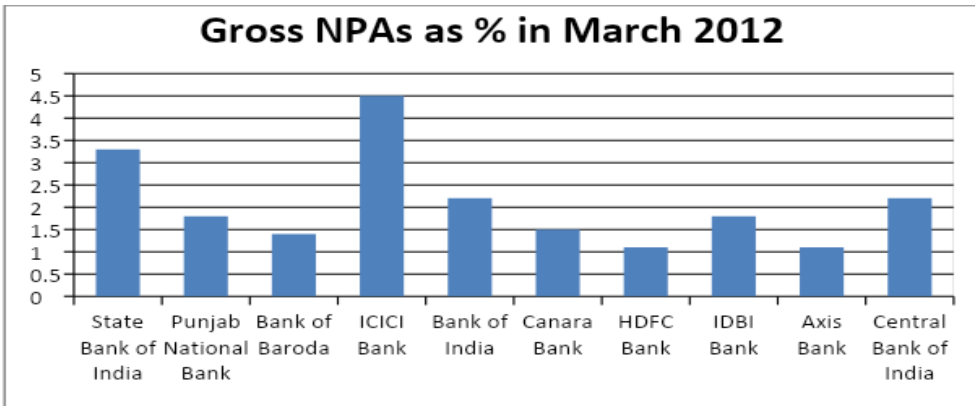


Figure- 6

Trends in NPAs are shown in figure- 6. 2002-03 is important year here as NPAs started declining and continue till 2006-07. Performance of public banks is better than that of the commercial bank here. Trends are same in total NPAs, NPAs of Public and Commercial Banks; there is difference of quantity only.



Source: Annual Reports, Results of banks, ICRA Research 2011



Source: Annual Reports, Results of banks, ICRA Research 2011

Figure- 7: (NPAs) in India (Ten Largest Banks)

CONCLUSION

GDP growth decreased immediately after the adoption of liberalization, and growth of money supply and credit creation also exhibited declining trends many times after the liberalization. The interest rate was expected to decrease after the liberalization, though nominal interest rates were declining after 1995-96 but hardly mattered for the rate of investment. Many times even with a decrease in the nominal interest rate, the real rate of interest increased due to the downward fluctuation of the inflation rate. Investment in govt. securities due to increasing yield exhibited increasing trends, credit to the government sector many times exceeded that of the commercial sector. These are signs of diverting resources from the productive sector to the government. Even after announcing a cheap monetary policy credit deposit ratio also exhibited decreasing trends, which is a question mark on the competitiveness of the banking sector. Increasing External Commercial Borrowings and other external sources available after liberalization had been competing with commercial banks and less demand for credit resulted in less credit creation and more investment in govt. securities. The money multiplier after showing somewhat increasing trends started declining after 1995-96. The currency ratio which is an important component of the money multiplier also reflects the banking habits of people with more use of demand deposits than currency is a good sign but no declining trends could be seen in the currency ratio. From 2002-03 to 2007-08 exhibited a declining trend but still remained greater than unitary. NPAs exhibited a declining trend from 2001-02 to 2005-06 but started increasing immediately after that, with the commencement of recession rate of increasing NPAs hiked. The amount of NPAs is higher in commercial banks as compared to that of public sector banks. The present paper calls for further study of a variety of challenges arising in a changing economy.

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