Financial Deregulation in India

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Abstract

Revolution in institution reforms in India has now extended to the financial sector. The financial sector has been hit hard by the stock market scandal of 1992. But the scandal and the subsequent inquiry into the scandal has also brought about many institutional changes such as the banning of informal futures trading. Domestic banks have been forced to change their practices for meeting the demands in the financial sector accompanying the growth in the general economic activities. We evaluate the past, the present and the future of the financial sector.

Introduction

India has gone through a quiet revolution since 1991. This revolution is catching up the banking sector now. The results of this revolution can be seen in any big city in India. Prospectus for new shares and bonds are available at the corner cigarette shops in central Calcutta—along with Pepsi, and saffron flavoured chewing tobacco. This is the brave new privatised world of India. Imagine the hot dog/pretzel sellers in New York or vendors in Pitt Street selling prospectus for an IPO!

The Bombay Stock Market top 30 index (Sensex), the Indian equivalent of the Dow Jones Industrial Average, registered a new high for 1994 on June 20 at 4344. Since then, it has fallen to around 3200 (April 1995) on the news of the electoral defeat of the ruling Congress party in many states recently.

Facts about Capital Markets

Capital markets in India has grown enormously.

- Estimated market capitalisation is in the neighbourhood of US$ 100-120 billion.
- In the past fifteen years, Indian capital markets have grown by a factor of 16.
- There are 20 to 30 million shareholders in India, in addition to owners of mutual funds.
- Private sector mutual funds have been allowed to enter the market to compete with the original government owned mutual fund companies.
- Capital market has shown maturity in handling large volume of transactions by the Foreign Institutional Investors (FII). FIIs have transacted over US$ 5 billion since November 1993 (with a four billion dollar investment into India and one billion dollars worth of withdrawal from India).

Corporate sector in India has shown significant growth in sales and profits. With a few exceptions, the largest 100 corporations have shown a growth in profits of 20-50% over last year. Most of these increases have come about from a strong increase in domestic demand (up by 25%) as well as a substantial rise in exports (up by 20%). Many of the smaller companies have shown even faster growth.

Despite the crisis in emerging markets elsewhere (eg., Mexico) Foreign Institutional Investors are still coming into the Indian stock market. On August 1, 1994, Baring Securities' Report on Emerging Markets, the investors have been advised to increase their Indian portfolio from 11.5% to 19.9% (Economic Times, 1994).

Developments in Banking Sector

In the financial markets, banks play a prominent role. The banks in India have been dogged by excessive government regulations for many years. In 1955, the Imperial Bank was nationalized and renamed the State Bank of India. To demonstrate the power of the prime minister's office, Indira Gandhi nationalised fourteen largest private sector banks in 1969. She gained enormous political support for this move. Middle class voters obtained a cheap source for borrowing money as the government froze the interest rates. All rates were fixed at uneconomic levels for the depositors. Reserve requirements were set at very high levels so that the government could borrow from the public sector banks at below market rates of interest. Nationalised banks also have a large proportion of "non-performing" loans. The current accounting methods do not allow for taking these loans into account.

Important reforms are taking place in the way the government regulates the banking sector. Banks now have to adhere to international accounting practice of taking into account the non-performing loans. They have to satisfy capital adequacy requirements. Most importantly, the Government of India (GOI) has decided to deregulate the interest rates in most parts of the market. Thus, banks can pay and charge the "market" interest rate for any of their loans. The GOI has also decided not to borrow money from the banks at a rate

below the market rate. In future, it will only borrow at the market rate. This step will definitely deepen the market. We summarise the developments in banking sector below:

- GOI will restrict its use of ad hoc treasury bills from financing government deficits. It will phase out this source of funding by 1998.
- GOI will reduced the reserve requirements of commercial banks.
- Interest rates on loans and deposits are liberalised.
- International income recognised, asset classification and provisioning norms introduced.
- GOI ownership of nationalised banks is being diluted.
- Approval has been given for the establishment of ten private sector banks (although only five have actually been operating).
- Restriction on the establishment and expansion of foreign banks have been eased and their shares of the Indian market has increased.

Regulatory Reforms for the Financial Sector

In January 1995, the Securities and Exchange Board of India (SEBI) was given the needed autonomy to set up futures and options markets. SEBI also has the power to impose penalties for brokers in breach of any contract for transactions. It will also supervise the banks to lend money against shares and commercial papers.

What Should the Government Do?

In a survey by a leading business magazine in India, a number of leading businessmen was asked what they thought were the main problems facing the current economic reform program. One item topped the list *for all of them:* the lack of infrastructure development (Business World, 1994). Government of India has recognised the problem. It has embarked on alleviating problems of telecommunications, transport and other bottlenecks arising from the lack of infrastructure through gradual privatisation. These steps have been taken, not as parts of a grand plan but on a piecemeal basis—because some of these steps are bitterly opposed by powerful public sector unions. The government has moved carefully between opposing interests of the expanding business sector and the unions.

Infrastructure development has also become the catchcry for international donor agencies. The new 1994 World Development Report by the World Bank has been devoted entirely on this new *mantra* of infrastructure development (World Bank Development Report, 1994).

The Government of India has made one thing clear: it does not wish to expand public sector enterprises unless they have commercial viability. It wants to introduce competition from the private sector in areas where the government had monopoly.

Deregulation and Privatisation in Physical Infrastructure

Power

To bring reliable uninterrupted power supply, India will need at least 240,000 megawatts of power compared with 70,000 megawatts installed capacity now. In 1994, the Government of India asked Professor Michael Porter, a Harvard economist, to provide a confidential assessment for identifying weakness in power generation and supply. Professor Porter identified three main problem areas: (1) inefficiency, (2) theft and (3) corruption. Surprisingly, the report did not mention anything about the relationship between the states and the central government. In India, power generation is a central government responsibility. State Electricity Boards undertake the distribution of power supply. Endemic corruption at the state level government ensures that at least 30% of the consumers (notably, slum dwellers in cities and farmers in canal/well irrigated areas) pay zero price. These groups also wield enormous power in state political scene. Thus, it is impossible for the central government to enforce user pay principle without the support of the state governments. To date, there have been no on-going dialogue between the state and central governments on this issue.

On the positive development, the central government has taken steps to increase capacity in the power sector. Government of India decided to attract foreign investors to invest in power sector by guaranteeing the rate of return on investment on the bonds (the Global Depository Receipts or GDRs) issued by the state power supply companies in US$ terms. The rate of return (with certainty) was set at 16%. In the OECD world, with much lower riskless rate of return on bonds, the GDRs were oversubscribed. The increased demand for GDRs also increased the demand for the Indian rupee. This development resulted in an upward pressure on the value of the rupee. For the first time in history, the Reserve Bank of India was forced to buy foreign currency to keep the value of Indian rupee down. This could have been seen as a positive development for India had it not been the case that the government had distorted the market demand by rate of return guarantee beyond the market rate. When these GDRs mature, the government has to make good of its promise of the guaranteed rate of return and pay the foreign investors regardless of the actual rate of return. Given the bad experience of the past, it is hard to see how the government can avoid subsidising the bonds in the long run. There is an additional agency problem. Because the government has provided a blanket guarantee, the foreign investors will spend less resources to monitor the activities of these power generation projects.

Roads

India has 760,000 kilometres of paved road. For a more efficient transport, better road links are necessary. Except for National Highways, all other roads are state responsibility. A few state governments (most notably, Maharashtra, Karnataka, Madhya Pradesh and West Bengal) have started preliminary talks with private investors (both domestic and foreign—mostly Non-Resident Indians) to open and operate toll roads. Unfortunately, the appropriate institutional framework to regulate such monopolies does not exist. The states and the central governments are yet to sort out legal

aspects of such provisions (for example, Who gets what share of the revenue generated? How to manage the expenditure and who finances what?)

Railways

Indian Railways is the largest employer in the world employing some 1.6 million people and operating some 75,000 km of track. Government has not even talked about privatising railways. However, it has decided to contract out luxury trains (the so-called Palace on Wheels), to the private sector. For modernisation, Indian Railways needs massive infusion of capital. It needs to upgrade the existing stock of trains. It needs to improve efficiency. Unfortunately, improvement in efficiency will also require elimination of jobs. Railways has powerful unions. To retain their support for the government and to avoid disruption in train service, the government is unable to take these bold steps.

Telecom

Nowhere has the start again stop again nature of the reform process in India been more prominent than in telecommunications. In January 1994, the Prime Minister set up a committee called Joint Intelligence Committee (JIC). It included people from the Home, Finance, Communications and Defence Ministries. It concluded that for strategic reasons, the Department of Telecommunications (DOT) should not allow for more than 40% equity participation of multinationals and other foreign companies. A domestic company, Reliance Industries Limited (RIL), put forth an ambitious plan to the DOT for modernisation of telecommunications in India. It called for a plan to clear 60% of backlog of demand for new telephones within three years at a cost of US$1.5 billion. It wanted to add 10 million telephone lines by the year 2000 with the help of technology leaders like AT&T. The proposal did not get much support from the central government because the government did not want to relinquish majority share holding of telephone service to a private company.

The multinationals stuck to their guns on majority equity participation. In August 1994, the government changed its stance on telephone. It decided to divide the country into 18 regions (called "circles") and allow foreign firms and joint ventures to operate monopolies in each region. However, the DOT is still to maintain its monopoly on connecting each of the 18 regions. Each of the 18 region has approximately 50 million people and thus a viable "circle". However, the regions vary enormously in terms of wealth and income. Therefore, the multinationals will probably be interested in some of these circles but not others. Motorola Inc. and Malaysian Telecom joint venture has already bagged the first circle around Calcutta.

The Minister for Telecommunication opening a major Telecom show in India in November 1994 invited foreign telecommunications firms to set up factories in India saying a massive pent-up demand for phones could fetch them huge profits. He argued that "those who set up manufacturing here can sell as much as 50 percent of their production in the local market. They will have to look for a market for only half of their production," He said India's new economic policies, which reduced the government's role in the telecommunication industry and eased foreign investment regulations, should encourage overseas phone companies to make India their manufacturing base.

Why is the DOT changing its mind about telecommunication so frequently? Clearly, the minister is worried about the organised 500,000 strong union of the DOT. On the other hand, he was under pressure from the Prime Minister and other ministers to carry out necessary reforms under his own ministry. In the end, it looks like the reformists scored a minor victory in the area. If all parties do not coordinate their activities properly (and since they all have different motives, they might not cooperate), those 18 circles might turn into vicious little circles.

Television

Since deregulation began in 1991, the state run television, Doordarshan has been steadily losing market to the satellite television mainly beamed from Hong Kong. In 1994, Doordarshan has allowed the Metro Channel, telecast in 18 major cities to run as a "profit centre" and allowed it to have more autonomy in programming. As a result, the Metro Channel has been able to claw back some of the market share. This may be turn out to be the method of privatisation through the back door.

Airlines/Airports

In 1994, a powerful committee, headed by Mr. R. N. Sharma, produced a report on the projected demand for aircraft, personnel and airport facilities over the next twelve years. The report estimated that India will buy over US$16 billion aircraft over the next 12 years with a rise of domestic air passengers to 40 million and international passengers to 17 million.

Government of India has also taken the first tentative steps to introduce competition in the domestic airline market. It has allowed 17 "Air Taxi Operators" to fly in some routes in India. Four major ones, East-West Airlines, Damania Airways, Modiluft, and Jet Airways account for over 75% of the total revenue of the Air Taxi Operators. With the pressure from the unions of Air India (the international arm of the state owned airlines) and Indian Airlines (the domestic arm of the state owned airlines), it did not allow full freedom of operation (choosing routes, getting better location at the airports). Despite these handicaps, the fledgling private airlines have done remarkably well. They have managed to increase their revenue in 1994 whereas both Air India and Indian Airlines continued to mount losses. Although in terms of size, the Air Taxi Operators account for less than 25% of passengers travelled, they have definitely forced the state owned airlines to take a hard look at their inefficiencies.

Financial Deregulation in Currency Convertibility

To understand financial deregulation in India, we need to go back to July 1991.

In mid-1991, India was at a crossroad. India's foreign exchange reserves were down to almost zero. The newly elected Congress Party was able to form the Government only with the help of left wing smaller regional parties. Inflation was running at double digits. Indian government was seeking *emergency* loan from the International Monetary Fund (IMF) for the first time in July 1991.

The most pressing problem was the balance of payment crisis. The crisis had two (unanticipated) causes: (1) the Gulf War leading to a large exodus of Indian workers from the Middle East back to India depriving her of substantial invisible export. India imported additional price rises in the form of higher oil prices. (2) Collapse of India's main trading partner: the Soviet Union.

Indian policy makers believed that any deregulation *within* the economy must go hand in hand with integration with the world economy. This was not the model followed by most other Asian countries in the past such as Korea or even Japan.

A prerequisite for integration with the rest of the world was taken to be integration of Indian rupee in the world currency market. Indian rupee, like many other currencies of developing countries, was overvalued. As a consequence, an elaborate "havala" (Hindi word meaning unofficial or parallel) market developed. Before moves to convertibility, havala rates remained at 20-25% above the official rate. It was thought by the RBI that a sudden full convertibility would bring chaos to the currency market. Therefore, the RBI decided to make Indian rupee convertible in several steps. First step was to make any transaction convertible with a 60-40 split: 60% of the money would be convertible at the "market" rate and the rest of 40% at the official rate. The second step would be "full" convertibility on trade account. However, this is not to be confused with unrestricted purchasing rights of Indians in markets abroad or unrestricted purchase by foreigners in Indian markets. There are still *quantity* restrictions. However, *all of* permitted goods will be allowed to be converted at the market rate. The third step will be full convertibility in the sense used by OECD countries.

The first step was implemented in July 1991 with a 20% devaluation of the rupee. The value of rupee in the official market fell somewhat and got closer to the havala rate. The premium for the havala rate declined to about 17%.

An important second step was taken on March 2, 1993. Partial convertibility of rupee was changed to full convertibility on trade account. That is, the market was allowed to determine one single rate and *all* transactions took place at that rate. This move was unanticipated by the exporters and other traders who use rupees for foreign currency.

Many commentators expected the rupee to fall substantially below 31 rupees per US$ (the exchange rate at the time). However, this did not happen at all. At first, the value of the rupee fluctuated wildly but then, within a month, it started to trade in a narrow band. The premium in the havala market almost evaporated. Today, the premium is no more than 2-3% above the market rate.

In late 1993 and early 1994, Indian businesses started to borrow in the Eurobond market to raise capital, thus raising the demand for Indian rupees. Rupee started appreciating against major foreign currencies. Under pressure from exporters, the Reserve Bank of India intervened in the currency market to keep the rupee *down* for the first time in its history.

Three years after the crisis of depletion of foreign exchange reserves, India is now saddled with *too much* foreign reserves (about US$16 billion). This development has prompted speculations that India is about remove all restrictions in transactions in Current Accounts.

The Role of the Foreign Banks

Foreign banks did not come under the sweeping net of nationalisation. Two large foreign banks operated vigorously for corporate business: Citibank and ANZ-Grindlays. Other banks such as Hong Kong Bank, Standard Chartered Bank, American Express and Chase Manhattan Bank also had strong presence. Until recently, they were discouraged from expanding their retail business.

Compared with currency reforms, changes in the banking sector have been slow. In 1992, the government opened the banking sector to private banks. In early 1994, at least eight private banks have begun operating. One of them (operated by the Unit Trust of India—the largest mutual fund in India) is expanding rapidly in urban areas.

There are two major problems with the nationalised banks: (1) They are saddled with at least 10% "non-performing" loans. (2) They have strong workers' unions. The first problem affects their revenue side. Unions are strongly opposed to automation, elimination of jobs, and changes in work practices. All three are detrimental to cost side of the banks' balance sheets. These problems will be difficult to overcome in the short run.

Future for Foreign Banks

In August 1994, Chase Manhattan Bank got the approval for upgrading its representative office into a branch bank status. For the past decade, Chase has been arranging foreign exchange loans for the public sector companies to the tune of US$2 billions or more. It expects to do the same for the private sector from now on. (Communique 1994)

The role that the foreign banks played in the recent surge of foreign investment in India has not been understood very well. In addition to broking firms like Morgan Stanley, foreign banks such as Citibank and ANZ Grindlays have been instrumental in foreign investment in India.

ANZ Grindlays and Citibank suffered a setback after their alleged involvement in the share market scandal in 1992. They are both on retail business with great success. Their streamlined operations, computerisation and consequent quick service cannot be duplicated by the state owned banks soon. However, their ATM service and foreign exchange transactions' facilities are being provided by many domestic banks. The presence of foreign banks will force the domestic banks to upgrade their services.

As India grows, opportunities for foreign banks will be concentrated in the currency market. However, with integration of the capital markets in India through joint ventures and foreign investment, foreign banks will have a chance develop long term presence in the domestic capital markets.

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Table 1 Economic Indicators of India

Indicator	Value
Gross Domestic Product (GDP)	US$1062 billion (PPP adjusted)
GDP growth rate	1994: 6.0% (est.)
Foreign Debt (Dec. 1993)	US$73.5 billion
Short term interest rate	16%
Market Capitalisation	US$130 billion
Listed companies	over 7000
Population	902 million
Middle Class population	150-200 million
English speaking	60 million
Investors	25-30 million

Sources: The Economist, January 15, 1994, and Asiaweek, February 2, 1994