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FISCAL POLICY IN BANKING SECTOR IN INDIA

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ABSTRACT

Financial sector reforms were initiated as part of overall economic reforms in the country and wide ranging reforms covering industry, trade, taxation, external sector, banking and financial markets have been carried out since mid1991. A decade of economic and financial sector reforms has strengthened the fundamentals of the Indian economy and transformed the operating environment for banks and financial institutions in the country. The sustained and gradual pace of reforms has helped avoid any crisis and has actually fuelled growth. As pointed out in the RBI Annual Report 3 decade 1980-81 to 1989-90,1991-92 to2000-01 and 2001-2002 to 2010-2011 , GDP growth in the 10 years after reforms i.e. 1992-93 to 2001-02 averaged 6.0%against 5.8% recorded during 1980-81 to 1989-90 in the pre-reform period. And moderate in last decade.

Key word : Fiscal , decade, reform , NBFCs, micro and macro, post-WTO

INTRODUCTION

An India are most achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc. At the same time, liberalisation has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs, post office, etc. Post-WTO, competition will only get intensified, as large global players emerge on the scene. Increasing competition is squeezing profitability and forcing banks to work efficiently on shrinking spreads. Positive fallout of competition is the greater choice available to consumers, and the increased level of sophistication and technology in banks. As banks Benchmark themselves against global standards; there has been a marked increase in disclosures and transparency in bank balance sheets as also greater focus on corporate governance.

MAJOR REFORM INITIATIVES

Some of the major reform initiatives in the last decade that have changed the some of the major reform initiatives in the last decade that have changed the face of the Indian banking and financial sector are:

- Interest rate deregulation. Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates.
- Adoption of prudential norms in terms of capital adequacy, asset classification, income recognition, provisioning, and exposure limits, investment fluctuation reserve, etc.
- Reduction in pre-emotions – lowering of reserve requirements (SLR and CRR), thus releasing more lend able resources which banks can deploy profitably.
- Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.

- Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater flexibility in recruitment.
- New private sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up Offshore Banking Units in Special Economic Zones.
- New areas have been opened up for bank financing: insurance, credit cards, infrastructure financing, leasing, gold banking, besides of course investment banking, asset management, factoring, etc.
- Several new institutions have been set up including the National Securities Depositories Ltd., Central Depositories Services Ltd., Clearing Corporation of India Ltd., Credit Information Bureau India Ltd.
- Limits for investment in overseas markets by banks, mutual funds and corporate have been liberalized. The overseas investment limit for corporate has been raised to 100% of net worth and the ceiling of $100 million on prepayment of external commercial borrowings has been removed. MFs incorporates can now undertake FRAs with banks. Indians allowed maintaining resident foreign currency (domestic) accounts. Full convertibility for deposit schemes of NRIs introduced.
- Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.
- Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer,

Centralized Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.

- Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc. are being adopted.

Improvement in performance of commercial banks

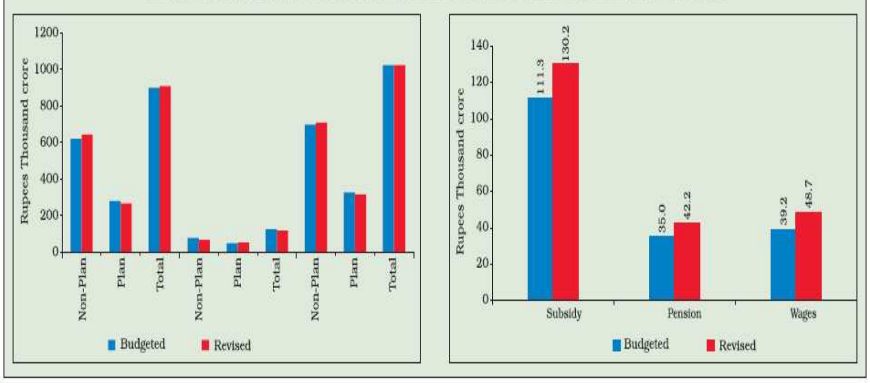


Chart II.47: Budgeted and Revised Expenditure of the Central Government in 2009-10

There is no doubt that banking sector reforms have increased the profitability, productivity and efficiency of banks. There has been an improvement in overall capital adequacy of banks and as on March 31, 2002 92 out of 97 commercial banks operating in India had capital adequacy above the statutory minimum level of 9%. Introduction of prudential norms relating to asset classification, income recognition and provisioning, along with legal and institutional reforms, has led to visible improvement in asset quality in banks. Net NPAs (i.e.that portion of NPAs which is not provided for) have declined gradually from 10.7% in 1994-95 to 5.8% in 2001-02.Increase in the number of players has increased competition, which is reflected in the decline in the bank concentration ratio. The share of top 5 banks in total assets declined from51.7% in 1991-92 to 43.5% in 2001-02 while its share in profits fell from 54.5% to 41.4% in the same period. Despite intensification of competition and introduction of prudential norms, all major bank groups in India have remained profitable. The Return on Assets has hovered in the range of0.5-0.8% since the mid-1990s – while this is on the lower side compared to many developing countries, it is higher than the Profitability at around 0.5% in industrialized countries. The improvement in efficiency is also seen from the intermediation cost for scheduled commercial banks, which declined from2.85% in 1996-97 to 2.19% in 2001-02·. According to data analyzed by RBI, there has been a noticeable decline in the difference between real interest rates in India and international benchmark rates (LIBOR 1 year) since the mid-1990s,suggesting increased integration of the Indian banking sector with the rest of the world. The government also extended the reduction in excise duty rates by4 percentage point effective from December 7, 2008to the fiscal 2009-10, besides further reducing the general rate of central excise duty from 10 per cent to 8 per cent and services tax rate from 12 per cento 10 per cent. These Measures planned for 2010-11 indicate both beginning of fiscal exit as well as emphasis on the quality of fiscal adjustment. Along with these, the Medium Term Fiscal Policy Statement (MTFPS) also offers a medium term fiscal consolidation path, in terms of rolling targets for key parameters of fiscal consolidation. RD and GFD have been planned tube brought down to 2.7 per cent and 4.1 per cento GDP, respectively, by 2012-13.

Challenges Ahead

(i) Improving profitability: The most direct result of the above changes is increasing competition and narrowing of spreads and its impact on the profitability of banks. The challenge for banks is how to manage with thinning margins while at the same time working to improve productivity which remains low in relation to global standards. This is particularly important because with dilution in banks' equity, analysts and shareholders now closely track their performance. Thus, with falling spreads, rising provision for NPAs and falling interest rates, greater attention will need to be paid to reducing transaction costs. This will require tremendous efforts in the area of technology and for banks to build capabilities to handle much bigger volumes.

(ii) Reinforcing technology: Technology has thus become strategic and integral part of banking, driving banks to acquire and implement world class systems that enable them.

To provide products and services in large volumes at competitive cost with better risk management practices. The pressure to undertake extensive computerization is very.

Real as banks that adopt the latest in technology have an edge over others. Customers have become very demanding and banks have to deliver customized products through multiple channels, allowing customers access to the bank round the clock.

(iii) Risk management: The deregulated environment brings units wake risks along with profitable opportunities, and technology plays a crucial role in managing these risks. In addition to being exposed to credit risk, market risk and operational risk, the business of banks would be susceptible to country risk, which will be heightened as controls on the Movement of capital is eased. In this context, banks are upgrading their credit assessment and risk management skills and retraining staff, developing a cadre of specialists and introducing technology driven management information systems.

(iv) Sharpening skills: The far-reaching changes in the banking and financial sector entail a fundamental shift in the set of skills required in banking. To meet increased competition and manage risks, the demand for specialized banking functions, using IT as a competitive tool is set to go up. Special skills in retail banking, treasury, risk management, foreign exchange, development banking, etc., will need to be carefully nurtured and built. Thus, the twin pillars of the banking sector i.e. human resources and IT will have to be strengthened.

(v) Greater customer orientation: In today's competitive environment, banks will have to strive to attract and retain customers by introducing innovative products, enhancing the quality of customer service and marketing a variety of products through diverse channels targeted at specific customer groups.

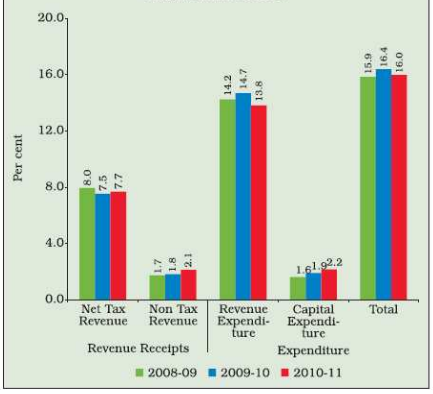
(vi) Corporate governance: Besides using their strengths and strategic initiatives for creating shareholder value, banks have to be conscious of their responsibilities towards Corporate governance. Following financial liberalisation, as the ownership of banks gets broad based the importance of institutional and individual shareholders will increase. In such a scenario, banks will need to put in place a code for corporate governance for benefiting all stakeholders of a corporate entity.

(vii) International standards: Introducing internationally followed best practices and observing universally acceptable standards and codes is necessary for strengthening the domestic financial architecture. This includes best practices in the area of corporate governance along with full transparency in disclosures. In todays globalize world, focusing on the observance of standards will help smooth integration with world financial markets.

In sustaining the expansionary stance to stimulate the economy, while expenditure Measures continued to dominate, stimulus through tax cuts increased during 2009-10. Expenditure on various social sector projects such as under sectional Rural Employment Guarantee Act (NREGA) increased significantly and the permanent impact of the Sixth Pay Commission award on income also helped in containing the rate of deceleration in private consumption demand.

Accordingly, total expenditure as percentage of GDP increased by 0.5 percentage point during2009-10 over the previous year. The government also extended the reduction in excise duty rates by4 percentage point effective from December 7, 2008to the fiscal 2009-10, besides further reducing the general rate of central excise duty from 10 per cent to 8 per cent and services tax rate from 12 per cento 10 per cent.

Chart II.46: Ratio of Revenue Receipts and Expenditure to GDP

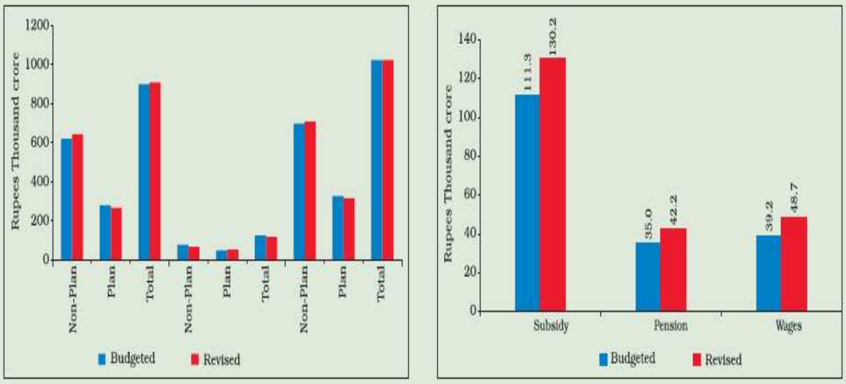


These steps were taken despite further widening of RD and GFD to alleviate the inflationary impact of global price rise as well as to boost aggregate demand. Reflecting these measures, as percentage of GDP, net tax revenue declined by 0.5 percentage point (Chart II.46).

During 2009-10, fiscal stimulus measures as per cent of GDP moderated to 1.8 per cent from2.4 per cent in 2008-09. Moreover, qualitativesition of fiscal stimulus was also evident during 2009-10. Expenditure was better targeted to spur aggregate demand and to add to the capacity creation through increased focus on social and physical infrastructure. Hence, capital expenditure increased by about 28 per cent vis-à-vis 14 per cent rise in revenue expenditure during 2009-10. In adopting an expansionary stance on the expenditure side, the allocation between revenue and capital expenditure has to Be seen in relation to the choice between what type of expenditure would spur growth with Limited lagan what type of expenditure may involve a larger lag but exert less pressure on medium-term fiscal sustainability. Capital expenditure, unlike revenue expenditure, is expected to create cash flows in future, which in turn, would service the debt that would have financed the capital expenditure.

Capital expenditure in the revised estimates of 2009-10 fell short of the envisaged level by 6.8 per cent, due to the non-plan component, which fell short by 16.2 per cent. There was corresponding revenue expenditure Overrun by 1.0 per cent, as revenue expenditure was higher by 3.7 per cent than the budget Estimates, owing to overruns in salary, pension and subsidies (Chart II.47).

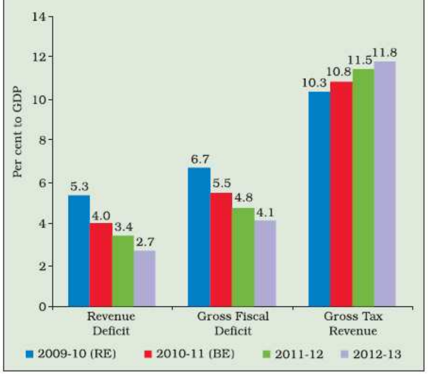
Chart II.47: Budgeted and Revised Expenditure of the Central Government in 2009-10



The increase in salary expenditure was overhand above the payment of arrears from Sixth Pay Commission awards, which were part of the budget estimates. Though these additional expenditures were not strictly a part of deliberate steps taken to spur recovery in growth, given the timing and quantum, they effectively worked as stimulus to the economy during 2009-10. On the non-plan expenditure side, higher interest payments were primarily a reflection of the higher borrowings in the previous year, and not necessarily part of stimulus measures. Such expenditure may have tube seen as the cost of past stimulus rather than stimulus in itself.

Fiscal Correction and Consolidation

Chart II.48: Rolling Targets under the Medium Term Fiscal Policy Statement

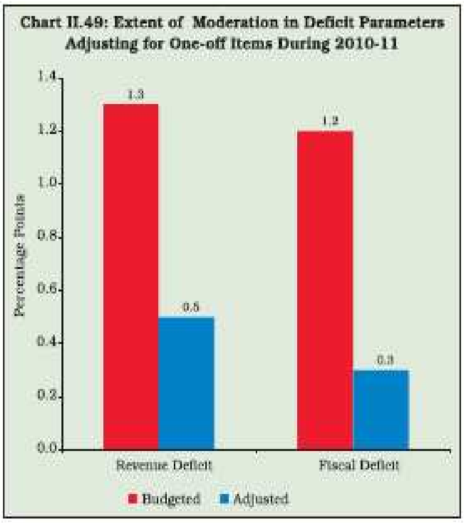


The extraordinary fiscal stance adopted during 2008-09 and 2009-10, to a large extent, achieved the short-term objective of containing the economic slowdown and stimulating the economy thereafter. As the prospects of sustained economic recovery became increasingly evident during the course of 2009-10, the central government announced a gradual fiscal exit plan in the Union Budget for 2010-11. It aimed to bring down RD edged during 2010-11 through a combination of substantial increase in revenue receipts by 18.1 percent and non-debt capital receipts by 54.0 per cent, while containing the growth in revenue expenditure to 5.8 per cent (Chart II.48).

The robust growth in revenue receipts is premised on partial rollback of indirect taxes, anticipated revenue buoyancy from stronger growth and 3G/BWA spectrum auction proceeds. Revenue expenditure is expected to moderate on account of freezing the non-plan component almost to the level of the previous year, while capital expenditure has been budgeted to grow at 30.2 per cent during 2010-11.

These Measures planned for 2010-11 indicate both beginning of fiscal exit as well as emphasis on the quality of fiscal adjustment. Along with these, the Medium Term Fiscal Policy Statement (MTFPS) also offers a medium term fiscal consolidation path, in terms of rolling targets for key parameters of fiscal consolidation. RD and GFD have been planned tube brought down to 2.7 per cent and 4.1 per cento GDP, respectively, by 2012-13.

The quality of fiscal adjustment and the possibility of attaining the extent of consolidations per the envisaged plan in the short to medium term will be critically important to contain the fiscal risks to the medium-term macroeconomic outlook. The fiscal correction envisaged during 2010-11seems to rely significantly on one-off items of expenditures and receipts. Excluding one-off items such as arrears payments and farm debt waiver from the expenditure side, and disinvestment and3G/BWA spectrum auction proceeds from the receipts side, RD and GFD will show a correction of 0.5 and 0.3 percentage points of GDP over the previous year, respectively, as against 1.3 and 1.2percentage points reduction envisaged in the Budget (Chart II.49).

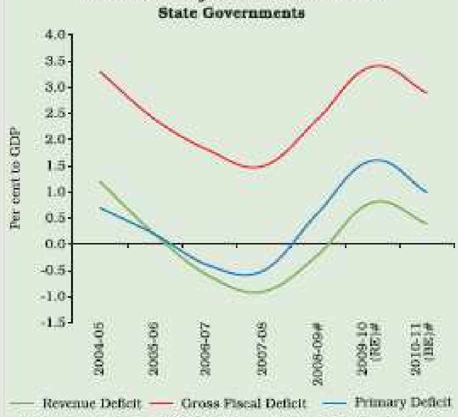


A substantial portion of the higher collections under 3G/BWA auctions would-be preempted by the net cash outgo of around`54,589 core on account of the first batch of Supplementary Demands for grants for 2010-11that were recently tabled in Parliament. Durable fiscal consolidation, however, would require correction on the recurring components of expenditure and receipts, and less reliance on one off items, as these options may not be available every year.II.5.9 The adjustment in RD as indicated in MTFPS also falls far short of the Thirteenth Finance Commission's (ThFC) recommendation to e move revenue deficit by 2013-14, which the government has accepted in principle. Going forward, it is amply evident that all the required adjustments in revenue/fiscal deficit over the next three to four years cannot be achieved through tax reforms envisaged under the Direct Tax Code (DTC) and the Goods and Services Tax (GST). In the MTFPS, the incremental gross tax revenue to GDP ratio resulting from these tax reform measures is estimated to be 0.7percentage points of GDP during 2011-12 and 0.3percentage points during 2012-13. This is much lower than the minimum corrections required to bring down the revenue deficit to zero. Therefore, besides tax reforms, expenditure reforms in terms of prioritization and rationalization would be crucial.

State Finances

During the period before the crisis, there was considerable improvement in consolidated fiscal position of the state governments as reflected in major deficit indicators, viz., revenue deficit (RD), gross fiscal deficit (GFD) and primary deficit (PD) as percentage of GDP (Chart II.50). Improved revenue receipts during the high growth phase and the responses of states to the incentives given by the Twelfth Finance Commission (TwFC) to implement their own fiscal responsibility legislations (FRLs) in the form of conditional debt restructuring and interest rate relief largely contributed to this progress. Since 2008-09, progress on is cal consolidation has been interrupted because of the impact of the slowdown in growth on revenues and the implementation of the Sixth Central/State a Commissions on expenditures. All major deficit indicators exhibited some increase during 2008-09and 2009-10, reflecting the combined effects follower revenue realization and higher expenditure Commitments.

Chart II.50: Major Deficit Indicators of State Governments



#: Based on budgets of 27 State Governments (excluding Tripura).

The impact of the slowdown in growth on state finances was much more visible in 2009-10(RE) over 2009-10 (BE) mainly on account of lower growth in revenue receipts. Both own tax revenues well as states' share in central taxes were lower than budget estimates for 2009-10. Revenue expenditure, however, recorded a marginal increase over budget estimates in 2009-10. In addition to deterioration in the revenue account, decline in non-debt capital receipts also contributed to higher GFD-GDP ratio in 2009-10 (RE) over2009-10 (BE), even though capital outlay by state governments declined.

Fiscal Dominance and Macroeconomic Conditions

Persistent large fiscal deficit has several adverse macroeconomic risks ranging from higher inflation, to lower savings, crowding-out pressures on private investment, decline in potential output, and worsening of external imbalances. While these concerns may be absent in the short-term in aphase of economic slowdown that requires the use of fiscal stimulus, in the medium-term these risks may materialise if the fiscal deficit is not brought down significantly under a credible fiscal consolidation strategy.

Risks to inflation from the higher levels of fiscal deficit in India resulting from fiscal stimulus measures during 2008-09 and 2009-10 remained contained till the first half of 2009-10, due to the following reasons:

(i) the fiscal stimulus, rather than creating any excess demand, partially offset the deceleration in private consumption and investment demand,

(ii) the fiscal stance and resultant financing of large borrowing programme did not cause any overshooting of money growth since private sector demand for credit remained subdued, and

(iii) Certain indirect tax rate cut measures led to lowering the prices of goods and services to some extent even though these measures yielded higher deficits. Rising and generalized inflation with increasing demand side pressures in the second half of 2009-10 suggested the need for timely fiscal exit to contain any fiscal risks to inflation.

Notwithstanding the absence of near-term risks to inflation from the fiscal conditions, however, there could be medium-term inflationary implications in the absence of a well designed fiscal exit in terms of timing and pace. Empirical evidence shows that even after the complete phasing out of automatic monetization of government deficit in1997, fiscal deficit still entails risks to the inflation path in India, in the medium to long-run. A fiscal deficit that emerges on account of revenue imbalance directly lowers the savings rate in the economy, as revenue imbalance amounts to

Fiscal Dominance and Risks to Inflation in India

In the developing countries context, inflation, at times, maybe comes effectively a fiscal phenomenon, since the fiscal stance could significantly influence the overall monetary conditions due to fiscal dominance. Sergeant and Wallace (1981) viewed that fiscally dominant governments running persistent deficits would sooner or later finance those deficits through creation of money, which will have inflationary consequences. Fischer and Easterly (1990) argued that rapid monetary growth may often be driven by underlying fiscal imbalances, implying that rapid inflation if almost always a fiscal phenomenon. In the Indian context also, several studies have shown that due to fiscal dominance there exists a nexus between government deficits, money supply and inflation, which may lead to a

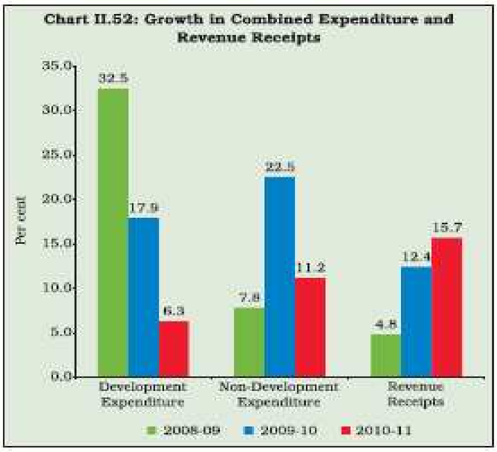


Chart II.52: Growth in Combined Expenditure and Revenue Receipts self perpetuating process of deficit-induced inflation and inflation-induced deficit (Sarma, 1982,Jadhav, 1994 and Rangarajan and Mohanty, 1998). Even after the complete phasing out of automatic monetization of deficit in 1997, government deficit continued to be a key factor causing incremental growth in reserve money on the sources side, and overall expansion in money supply and inflation (Khundrakpam and Goal, 2009).

The long-term inflationary potential of fiscal deficit could be analyzed by hypothesizing that either:

(i) there can be a direct impact on inflation through increase in aggregate demand; or

(ii) Indirectly through money creation or seignior age; or

(iii) A combination of both.

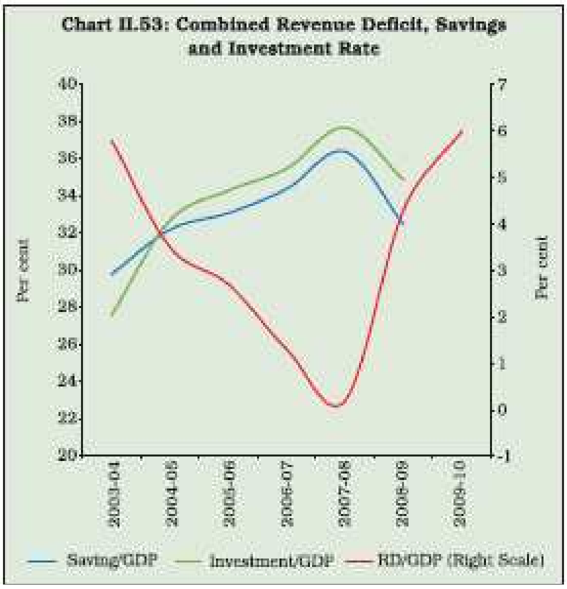
The counter rating long-run relationships estimated through ARDL approach during 1952 to 2009 reveals the following:

(i) Government resorts to seignior age to finance its deficit in the long-run;

(ii) Resorting to seignior age by the government influences the price level;

(iii) Government deficit also has direct causal Impact on the price level. In other words, ceteris paribus, price level in the economy in India, in the long-run, is influenced either directly by deficit itself or through the creation of money via deficit financing, or a combination of both. One per cent change in fiscal deficit is estimated to cause half a per cent change in seignior age ‘S’, defined as change in real reserve money:

Dis-savings of the government. There is no automatic mechanism that can raise the savings of households and corporate when dis-savings of the government rise. As a result, the overall saving rate of the economy may decline, which was evident in 2008-09 in the savings data. With the decline in combined revenue and fiscal deficit during 2003-04 to 2007-08 under the FRBM/FRLs, public sector saving had improved, which was an important Contributing factor behind the increase in overall saving and investment rate that propelled the high GDP growth, during that period. The higher GDP,in turn, facilitated reduction in revenue deficit ofthe government, by improving revenue buoyancy,thereby creating a virtuous cycle. But, with thesignificant jump in the revenue deficit of thegovernment during 2008-09 and 2009-10, theoverall savings and consequently investment rateshave also dipped correspondingly (Chart II.53).



A lower savings rate can affect the potential output path not only by depressing the investmentrate but also through altered resource allocation Because of the competition for resources betweenpublic sector and the private sector. Not with standing the contradictory evidence, the crowding-out impact generally remains moderate when fiscal policy behaves contra-cyclically. During1991 to 2009, there is some evidence of fiscal policy stance being contra-cyclical in the sense that fiscal deficit as a ratio to GDP declined during the period when output was above trend and vice versa. In other words, there was a negative correlation between output-gap and fiscal deficit. however, the bidirectional causality results suggest that fiscal policy not only tended to follow a countercyclicalbehaviour, but was also influenced by the business cycle in a fashion that could be viewed similar to activation of automatic stabilisers.

Besides the concerns relation to crowding out pressures and inflation, fiscal imbalances also entails the risk of widening the current account deficit. Due to the dominant role of remittances in moderating the magnitude of current account Imbalances, the twin deficit concerns often ascribed to fiscal deficit do not materialise in India. The imbalance between exports and imports (of goodsand services) as percentage of GDP, however, seem to validate the pressure that fiscal situation can exert on the country's external balance situation

CONCLUSIONS

The face of banking is changing rapidly. Competition is going to be tough and with financial liberalisation under the WTO, banks in India will have to benchmark themselves against the best in the world. For a strong and resilient banking and financial system, therefore, banks need to go beyond peripheral issues and tackle significant issues like improvements in profitability, efficiency and technology, while achieving economies of scale through consolidation and exploring available cost-effective solutions. These are some of the issues that need to be addressed if banks are to succeed, not just survive, in the changing milieu.

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