

**Discussants Comments by Montek S. Ahluwalia on the Paper on
“Financial Policies and the Prevention of Financial Crisis in
Emerging Markets”
by Frederic Mishkin, NBER Conference, Vermont**

I would like to join the other panelists in complimenting Rick Mishkin on an excellent paper. The twelve areas of financial policy he has identified reflect the current international consensus on how to avoid financial crises and most developing countries are moving broadly in the directions indicated. Marty has asked me to comment on the paper from the Indian perspective, so I will focus on how India's financial policies measure up against the template provided in the Mishkin paper.

A few words on recent economic developments in India may be useful by way of background information. India experienced a severe foreign exchange crisis in 1991 which led to the adoption of a programme of economic stabilization and structural reforms. The reforms were similar to those attempted by several other countries and involved a basic re-orientation of economic policy towards economic liberalization and greater integration with the global economy. They were broad based, in the sense of covering several areas such as industrial policy, trade policy, price decontrol, foreign investment policy and financial liberalization. However, the pace of reforms in India was much more gradualist than in most other countries, reflecting the difficulty in generating a political consensus in a large and highly pluralist democracy. The slow pace has taxed the patience of many otherwise sympathetic observers but it is important to note that the reforms have yielded positive results. The economy stabilized very quickly after the crisis of 1991 and the average growth in the post reforms period 1992-2000 was about 6.5%, making India one of the five or six fastest growing countries in this period.

An interesting feature of India's experience is the change from its fragile position in 1991, when it was overcome by a crisis, to the much stronger position in 1997 and 1998 when it was able to escape the East Asian contagion. It is relevant to ask how far this was due to India's policies having been brought in line with the prescriptions of the Mishkin paper and I hope I can throw some light on this question.

(i) Prudential Norms and Supervision

Reforms in the banking sector were an integral part of India's reform programme and some steps were taken even before the East Asian crisis improve prudential norms and to strengthen supervision. The process acquired a new urgency after East Asia, when financial sector weaknesses came to be seen as one of the principal causes of crises in emerging markets and there was a growing consensus that prudential norms and supervision standards should be raised to internationally accepted levels.

There has been a significant improvement in capital adequacy requirements and prudential norms in recent years. Banks are currently expected to maintain a minimum capital to risk assets ratio of 9% and this is to be increased to 10% by March 2002. The norms for income recognition, classification of non-performing assets and provisioning have also been tightened. However, since international norms are being implemented in a phased manner. Indian norms remain below the Basle Committee's minimum standards in some important respects. Loans are classified as sub-standard

only when debt service payments become overdue for 180 days whereas the international-norm is 90 days. The extent of provisioning for different categories of assets is also below the international level. The ultimate objective is to align the norms with international levels, but a firm deadline has not been specified.

A number of steps have also been taken to improve accounting standards and disclosure by the banks and to strengthen supervision. Traditional on-site supervision is being supplemented by a system of offsite supervision based on a regular flow of information from the banks and this is expected to allow closer and more continuous monitoring of asset quality, capital adequacy, large exposures, connected lending etc.

The need to strengthen regulation by establishing a system for prompt corrective action, which is specifically mentioned in the Mishkin paper, has been recognized. The RBI has circulated a discussion paper on this subject, proposing a system which establishes objective trigger points in three different dimensions of bank performance - capital adequacy, percentage of non-performing assets, and return on assets. If a bank's performance in any dimension deteriorates to a defined trigger point, it will automatically invite a set of mandatory actions by RBI. In addition, there are certain types of discretionary action which may be taken to improve performance. Implementation of this system will definitely improve the quality of supervision.

It is relatively easy to prescribe new norms, and even to introduce new supervisory systems, but this does not automatically ensure an improvement in the functioning of banks. That requires institutional changes in the internal functioning of banks, including especially improvements in the systems of credit evaluation and risk assessment, the quality of human resources and the quality of internal controls and governance. These changes can only be achieved over a period of time. I fully agree with the speaker who said that even after we decide to go down this route, it may take ten years to get there! 'This is especially so when reforms are being introduced in a non-crisis environment where the need for change may not be evident to all concerned.'¹

This is well illustrated by the position regarding capital adequacy in the Indian banking system. At present, 97 out of the 101 banks operating in India are above the 9% minimum level of capital to risk weighted assets. However, an independent credit * rating agency has pointed out that the position would look much less comfortable if the norms for classifying loans as substandard were immediately set at international levels and provisions had to be made accordingly. The problem would be further aggravated if the banks followed international practice in making provisions wherever loans are expected to deteriorate based on recent trends. The study found that most banks might fall below the 9% minimum.

The dilemma facing the regulatory authority is evident. A faster transition to international norms would have pushed many more banks below the accepted capital adequacy level, effectively restricting their ability to expand credit and possibly having a concretionary impact on economic activity. However, it would have strengthened the banking system faster. All banks would have been under greater pressure to improve performance and the better capitalized and more efficient banks would have gained market share relative to the weaker banks.

¹ A financial crisis, with a visible collapse of some financial institutions, creates a sense of urgency about the need for restructuring and the process is facilitated if failed institutions are taken over by foreign banks with large scale replacement of management systems and changes of senior personnel.

A peculiar feature of the Indian experience is that the benefits expected from better norms in terms of improved lending quality may be greatly reduced because the macro-economic environment is characterized by a high fiscal deficit.² The high deficit has produced high interest rates and have had the expected adverse selection consequence of discouraging high quality low risk borrowers. The crowding out on the side of demand for credit is reinforced on the supply side by the fact that banks have to meet high capital adequacy requirements for commercial assets while government securities are treated as zero risk assets, creating a strong regulatory incentive for investing in government securities. The net result is that banks are encouraged to invest in government securities, effectively crowding out bank credit to the private sector. The fact that Indian banks hold substantial volumes of government securities contributes to the financial stability of the system, but only at the cost of crowding out credit to the private sector, with a resulting loss in efficiency.

(ii) Reducing Government Ownership of Banks

The area where India's financial policies differ most distinctly from the international consensus relates to the role of public ownership of (the) banking system. The mainstream view, reflected in the Mishkin paper, is that government ownership of financial institutions is fundamentally inconsistent with sound banking and the role of government should therefore be drastically reduced, if not completely eliminated. However, public sector banks account for 82% of the total assets of the banking system in India and privatization is not on the agenda.

Government policy towards public ownership is being modified to allow public sector banks to raise equity capital from the market but this dilution is being driven not by the desire to reduce government's role in management but by the desire to meet capital adequacy requirements without having to provide capital from the budget. Initially, the reforms permitted dilution provided government equity remained at least 51%. More recently, the government has announced its intention to reduce its shareholding to a minority position (33%). In order to meet the additional capital needs of the banks, but it has also stated that while the government's shareholding will be reduced to a minority position, the "public sector character" of the banking system will be maintained. The exact meaning of this phrase has not been clarified, but it clearly implies that government will remain significantly involved in management.

Sceptics doubt whether any significant improvement can be achieved as long as government remains the largest single (albeit minority) owner, with the rest of the equity dispersed over a large number of shareholders. There are also doubts about whether sufficient private equity could be attracted to recapitalise the banks on these terms, since the shares issued by the public sector banks in the first stage of equity dilution are currently trading at a substantial discount to the issue price. However, the political resistance to privatisation of the banking system is very strong.³ In this

² The need to reduce the fiscal deficit was recognized as a priority objective from the very beginning of the reforms but progress in this area has been disappointing and the consolidated deficit of the Central and State Governments is almost 10% of GDP - about the same as just before the 1991 crisis.

³ Part of the problem is rooted in historical experience with private sector banking, before the nationalisation of the major banks in 1969. The banks were seen as captive banks of industrial houses with a great deal of connected lending. Lending to agriculture and small enterprises was minimal. The experience of privatization of the banks in many developing countries in the past twenty years is also not particularly encouraging.

situation, the best that can be expected is that reducing government equity to a minority position would enable the government to give bank managements a degree of flexibility and autonomy that would substantially improve their functioning.

It is difficult to judge how much autonomy is really possible. Reducing government equity to a minority will certainly enable government to free the banks from many of the cumbersome rules and procedures which are otherwise automatically applied to any institution in which government has more than 50% equity. They could be given much greater flexibility in hiring and promotion and their salary structure could be delinked from the salary structure of the government and the rest of the public sector. In principle, the public sector banks could be allowed to function as board managed institutions, in which the board would include some Government representatives, but would also include independent, professionally competent persons to represent private shareholders. It has been argued that if the top management team in such banks is appointed by the board, and not by the government as at present, the banks could achieve a significantly higher degree of management autonomy, and therefore of efficiency, even if it is less than is possible in a fully private sector bank.

Whatever happens to the public sector banks, India's financial reforms will definitely reduce the dominance of the banking sector by the public sector banks because the private sector segment (consisting of Indian private sector banks and foreign banks) is likely to expand very rapidly. An essential part of banking reforms was the grant of banking licenses to new Indian private sector banks and a more liberal policy for expansion of branches of foreign banks. As a result, the share of the private sector segment in total assets of the banking system, which was only 8% in 1990-91, increased to 18% in 1999-2000. The new private sector banks and the foreign banks do not have as large a branch network as the public sector banks, but they have other competitive advantages: they are less burdened with excess staff, have a high degree of managerial and operational flexibility, and are adopting information technology much more rapidly, enabling them to offer better services and also a wider range of products. Besides, the advantages of a very large network of brick and mortar branches are likely to reduce over time as information technology makes it possible to access quality clients without a larger number of branches. With continued financial liberalization, the share of the private sector segment could easily expand to 30% over the next five years.

Competition from efficient private sector banks and foreign banks will put pressure on the public sector banks to improve their performance and the stronger public sector banks can achieve much higher levels of efficiency if given operational flexibility. There is some evidence that they are making an effort. Several banks have attempted to reduce excess staff by offering generous voluntary retirement package. Though strongly opposed by the unions, this initiative has received a very positive response, with more than 10% of the employees opting for retirement. Further cost savings could be achieved by closing down loss making branches, which have tended to proliferate. Reduction in government equity to minority position will make it easier for the government to allow bank managements to explore these options without having the issues politicized.

The real challenge will be how to deal with the weak public sector banks which will be squeezed between the private sector banks which are expanding market share and the stronger public sector banks which will fight to maintain their share. Several public sector banks have been identified as being weak on the basis of capital adequacy and various efficiency related criteria. Of these, three were identified as the weakest, calling for one of

three options (a) closure or merger with another public sector bank, (b) change of ownership i.e. privatization and (c) comprehensive restructuring with a one time clean up of the balance sheet and continued operation as a public sector bank. The government has ruled out the first two options and indicated that it will recapitalize these banks, provided a restructuring plan is drawn up by the banks' managements, which is acceptable to the government and the RBI.

The credibility of this approach depends upon the extent of restructuring and cost reduction that can be brought about. There will have to be a substantial reduction in staff, possible acceptance of a freeze on wages and also closure of a sufficient number of loss making branches to create a smaller, leaner bank, which could become profitable. Without radical restructuring it will be difficult for these banks to survive in the more competitive environment they are likely to face in future.

The worst outcome for the future of public sector banks would be one in which regulatory forbearance - always a danger when there are public sector banks - allows these banks to continue to operate despite inadequate capital and without any significant restructuring. If closure or restructuring and privatization is not found to be politically acceptable, the regulatory system should at least insist on compliance with capital adequacy norms so that banks which fail to perform become "narrow banks", functioning as deposit taking institutions investing mainly in government securities, which does not require a strong capital base and does not pose any threat to financial stability. This would at least allow more efficient banks (both public sector and private sector banks) to expand and fill the space vacated by the weak banks, sending the right signal to other banks for the future.

The Indian banking system is also burdened with another feature which is not in line with mainstream views on good banking though it exists in other countries also in one form or another. This is the practice of directed credit. All Indian banks are required to ensure that 40% of their loans and advances portfolio is directed towards what is called the "priority sector" i.e. agriculture, small scale industry, small transport operators etc. Banks are not directed to lend to specific borrowers, but only to ensure sufficient allocation of funds to broadly defined sectors and the banks are expected to use normal credit assessment criteria to identify creditworthy borrowers within these sectors. However, this is clearly a quasi-fiscal activity. A large portion of priority sector lending is to small farmers and micro-enterprises and the interest rate for these loans is capped at the prime lending rate, which implies a significant subsidy given the high administrative costs and higher default risk of such loans. Strict adherence to sound banking principles calls for a removal of quasi-fiscal burdens. If subsidies have to be given, they should be given explicitly through the budget, a process which would „ automatically be subject to demands for scrutiny, transparency and most of all, effectiveness.

c) Legal and Judicial Issues

The legal and judicial system, which is listed as one of the twelve critical areas, is indeed a major problem area for banks in India, as in many emerging market countries. Indian banks are greatly hampered by legal procedures which make it difficult to attach collateral (especially real estate) and realize its sale value. The procedures regarding bankruptcy are also extremely cumbersome and liquidation of insolvent companies can take several years. This is undoubtedly one of the principle reasons for the relatively high level of non-performing assets in the banking system.

The government initially sought to deal with the problem by establishing specialized Debt Recovery Tribunals designed to enable banks

to take action for debt recovery within the existing laws through specialized courts empowered to use simpler procedures. This has helped to some extent, but the real lacuna is the lack of a modern bankruptcy law which would represent an appropriate balance between the rights of debtors and creditors, and allow creditors to force liquidation in the event of default after giving debtors a reasonable time to find a mutually acceptable solution. The government has announced its intention to amend the existing legislation along these lines and this would represent a major improvement in the situation.

c) Capital Controls

India's policy towards capital controls differs from the view advocated in the paper that controls on capital movement are not only inefficient, but also infeasible in the longer run because of leakages, and therefore should be avoided. This was also the view advocated by the IMF before the East Asian crisis but its approach has become more nuanced since then. Free mobility of capital is still regarded as a first best policy but the Fund now recognizes that it may be risky to move to full capital mobility until the financial sector has been sufficiently strengthened.⁴ An alternative view, articulated by Jagdish Bhagwati and John Williamson, holds that while there may be efficiency gains from liberalizing capital movements, the benefits are small and also uncertain. Bhagwati has argued that whereas there is a very strong empirical basis for asserting significant benefits from liberalization of trade and foreign direct investment, there is much less evidence for claiming similar benefits from liberalization of capital movements generally. On this view, emerging market countries should liberalise inflows of foreign direct investment, but they should continue to be cautious on liberalizing other capital flows. It is sometimes argued that full capital mobility is necessary to enable countries to attract much needed foreign direct investment. This argument is not particularly convincing since China does not allow full capital mobility and yet it is clearly the most successful country in attracting FDI. Foreign investors clearly need the assurance of being able to repatriate their capital at will, but full capital mobility may not be necessary.

India's policies are in line with the Bhagwati-Williamson prescriptions. Both foreign direct investment and portfolio investment in Indian stock markets have been greatly liberalized and these investors are also allowed to liquidate their investments and exit at will. Debt flows on the other hand are strictly controlled. Borrowing abroad requires government permission and the system is managed to ensure that total foreign borrowing in any year stays within some pre-determined "prudent" level. Furthermore, there are minimum maturity requirements which rule out short term borrowing, except for normal trade credit.

This policy paid dividends at the time of the East Asian crisis because India's external debt indicators had improved considerably compared to the situation in 1991 and this was surely one factor explaining why India did not suffer from contagion. Most important, India's short term foreign debt was only 25% of total foreign exchange reserves, compared with well over 100% for some of the crisis hit countries. This made India much less vulnerable to

⁴ It is interesting to note that the IMF position is somewhat asymmetric since countries that have liberalized the capital account but do not have strong financial systems are not being advised to re-impose controls. This would be understandable if financial systems could be strengthened very quickly, but as we have seen this is not a practical possibility. If strengthening the financial system is indeed a process which could take ten years, then there is a case for considering whether countries that have liberalized capital controls prematurely should not re-impose some form of control. However, there are no takers for this point of view in the Fund.

a cessation of commercial bank lending which was the principal cause of the massive reversal of capital flows in Fast Asia.

India's capital control regime not only restricts short term capital inflows but also controls capital outflows by Indian residents. While residents can obtain foreign exchange to make payments abroad for all current transactions they are not allowed to transfer funds abroad for capital transactions other than for repayment of external debt. In recent years, the system has been operated more liberally to allow Indian firms to create or acquire production or marketing capacity abroad as part of the firm's global expansion plans, or in support of an export drive. However, transfer of funds from India to hold financial assets abroad as an act of portfolio diversification is not allowed.

The original rationale for controlling capital outflows was that it will increase the resources available for investment domestically and this was perhaps justifiable at a time when foreign investment was not welcome and capital controls were seen as a » way to maximize the availability of resources for domestic investment. With foreign investment now welcome, this argument is no longer applicable since any capital outflow for investment abroad only vacates investment space at home, which in principle could be filled by foreign investment provided productive investment opportunities exist. In other words, liberalizing capital controls need not reduce the total level of investment but only alter its composition, with foreign investors acquiring domestic assets while domestic residents diversify their portfolio by investing abroad.

Indian policy makers are also keen to retain controls on capital outflows for another reason. In the absence of capital controls it is feared that a speculative attack on the currency could create expectations of devaluation which might trigger capital flight which would prove self-fulfilling. It is of course recognised that controls are porous and significant leakages take place over time, but it is felt that controls can be effective in preventing sudden outflows in a crisis situation. This is not to say that capital outflows should not be allowed under any circumstances. On the contrary, it is argued that the existing system can be operated to achieve whatever level of capital outflow is felt to be manageable in normal times, but the system of controls should be retained so that a sudden outflow can be prevented.

India is likely to continue with its present cautious policy on capital controls and a measure of caution in this area is perhaps justified on sequencing grounds. It would be better to get the fiscal deficit under control and have more progress on financial reforms before liberalizing the capital account. However there can be little doubt that the compulsions of globalisation will inevitably push India towards allowing greater flexibility. Indian firms will certainly need much greater freedom to invest abroad. Foreign investors locating production facilities in India will also demand greater freedom. At present, they have full freedom to take out their investment and exit at will, but they are subject to the same restrictions in their day to day operations that apply to other Indian companies e.g. they cannot borrow abroad without permission and such borrowings must conform to minimum maturity requirements even if they are from the parent company to its subsidiary in India. They are likely to demand flexibility for capital transactions comparable to that available in other countries. As the financial sector deepens, there will also be demands from institutions such as mutual funds and insurance companies to diversify their investments by holding some foreign assets.

India is likely to respond to these pressures by loosening existing restrictions in steps as it gains confidence in how to handle macro-economic shocks in an open economy. However, as capital flows are liberalized.

India's vulnerability on this account will also increase, and with it the compulsion to bring other financial policies in line with the requirements of crisis prevention.

d) Exchange Rate Policies

On exchange rate policies. India's practice compares well with the flexible exchange rate approach recommended in the Mishkin paper. The Reserve Bank of India has stated on many occasions that the exchange rate will be determined by market fundamentals (which it has been careful not to define) and there is certainly no commitment to maintaining a particular exchange rate. Past experience shows that the rupee has depreciated steadily against the US dollar (around 5% per year for the period 1996-200) and no reasonable investor would have any ground for believing that there is any kind of implicit exchange guarantee.

The exchange rate regime is not a completely free float in which the authorities abstain from any intervention, nor can this be expected, given the thinness of the foreign exchange market. The Reserve Bank intervenes (either through direct intervention in foreign exchange markets or through interest rate interventions) whenever it feels that the movement of the rupee is being driven by "temporary imbalances of demand and supply" or by "speculative pressure". It is of course difficult to tell whether a movement at any particular time reflects these factors or a change in fundamentals and this judgment necessarily must be left to the RBI. However it is clear that the RBI's interventions are in the nature of "leaning against the wind" to calm markets, rather than fighting against all odds to maintain a particular rate.

The RBI has been criticized for asymmetric behaviour because it is seen to fight much harder to prevent a nominal appreciation of the rupee than a depreciation. This happened during the period 1994 to 1996, when there were substantial inflows of portfolio capital. The rupee would have appreciated vis-a-vis the dollar if left to market forces but this was effectively prevented by the RBI's active intervention, which led to a substantial build up of foreign exchange reserves. In retrospect, the RBI's action seems entirely justified. His build up of reserves cannot be said to have been excessive, especially in the light of the East Asian crisis and the increased importance now accorded to maintaining high levels of reserves. Besides, the resistance to an appreciation in the nominal rate in that period also seems justified since the real effective exchange rate (REER) had already appreciated because the rupee was stable against the dollar which had appreciated against other currencies in this period. Further appreciation against the dollar would only have worsened the situation. Since the inflation rate in India exceeded the inflation rate in its major trading partners by 3 to 4% per year in this period, maintenance of the REER required „ a nominal depreciation not appreciation.

The relevance of the REER as a guide for exchange rate policy in India has varied. In certain periods, especially 1994-96. the objective of stabilizing the REER was officially stated on several occasions but the RBI never officially adopted an announced REER target. More recently, the RBI has described the REER as only one of the many factors that are relevant in determining what the exchange rate should be. This "constructive ambiguity" is perhaps unavoidable when operating a managed floating exchange rate regime.

India's exchange rate policies certainly helped to avoid problems which affected many other countries at the time of the East Asian crisis. The rupee came under pressure on several occasions in 1998, but the absence of a rigid exchange rate target meant that it was able to adjust in a series of small steps without attracting much criticism from foreign investors including

portfolio investors. Between June, 1997 and October 2000 the rupee depreciated against the dollar by around 23% which was about half of the depreciation in Thailand and Malaysia and only a little lower than Korea (which rebounded strongly in 2000). At no stage however did India look as if it was facing a currency crisis.

The logical development of exchange rate policy in future would be to learn to allow greater exchange rate flexibility with less frequent intervention by the RBI. The need for such flexibility will undoubtedly increase as capital controls are progressively liberalized increasing the possible pressure in foreign exchange markets from this source. The fact that import tariffs are still high, and the government has indicated that they will be lowered to East Asian levels in the medium term, suggests that there must be room for compensating depreciation to accompany tariff reductions. This adjustment would be much easier to achieve in a flexible exchange rate regime.

One consequence of allowing greater flexibility in the exchange rate is that the need for hedging instruments will expand. This in turn will put pressure on the system to liberalise capital transactions since it is not possible to develop an efficient market for hedging foreign exchange risk with the restrictive capital controls. Banks in particular will have to be given more flexibility to take positions in forward markets subject to reasonable risk limitations.

To summarize, India's financial policies are moving towards the direction indicated in the Mishkin paper in many respects but important gaps remain in some areas. Some of these gaps, especially those relating to prudential norms will be closed in a phased manner. There are important differences in certain areas, such as for example the role of government ownership in the financial system and the policy » towards capital controls. Some of these differences e.g. on capital controls, can be justified on sequencing grounds. On the whole, policies are converging towards those that are currently seen to be necessary avoid financial crises.
