International Journal of Engineering Sciences Paradigms and Researches (IJESPR)
Volume 47, Issue 02, Quarter 02 (April to June 2018)
An Indexed and Referred Journal with Impact Factor: 2.80
ISSN (Online): 2319-6564
www.ijesonline.com

Banking Sector after the Reforms in India

Dr. Punam Devi

Assistant Professor of Economics, Ganga Institute of Technology and Management, Jhajjar, Haryana (India)
punamhooda80@gmail.com

Publishing Date: June 20, 2018

Abstract

Various reforms have been carries out by our government as Jan Dhan Yojna, Digital India, Demonetization, ceiling on cash transaction etc. Future can be analyzed by the history and basic nature of economy and banking sector has been stagnant. Various reforms have been rolled out regarding banking sector from early nineties. Allowing foreign banks, deregulation of interest rates, decreasing bank rate 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 performance of banking sector and its impact on economy. Present paper will throw light on trends of real rate of interest, investment, credit growth, working of money multiplier. Banking habits of people are still not much modernized and use of currency is higher in economy. Lending rate were expected to be decreased after the reforms and providing enough liquidity to production sector but many times due to fluctuations in inflation rate real rate of interest has been also fluctuating. Impact of real rate of interest on investment is crucial to be studied.

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

Introduction

To accelerate economic growth of Indian economy through liberalization of sector like Agriculture, Industry, Trade etc. would have no meaning without liberalization of the financial and banking sector. Hence liberalization of the financial sector has been launched simultaneously to meet the growing demand of the aforesaid sectors as per recommendation of the Narasimham Committee on one hand and to ensure the stabilization of the economy on the other.

Consequently not only controls in the financial sector were loosened in terms of lowering bank rate, CRR, SLR etc. but removal of restrictions was carried for bringing improvement in the efficiency, productivity, profitability etc. through increasing competition in banking sector. Here we cannot ignore the effect of liberalization on credit creation, rate of interest, rate of investment and these are very important macro variables of an economy which play very important role not only in analyzing the level of growth of economy, but also in boosting its economic growth.

Banks and other financial institutions have been supposed to provide enough liquidity in the form of credit creation and availability of funds, especially after the liberalization. It is very important to study whether the liberalization of financial sector has generated the desired effect on economy or not.

Review of Literature

1. **Saggar (2003)** had made a study on trends of saving, investment and economic growth, and the relationships exist among them. He made a comparison between the pre- reforms and post-reforms era. He found that private corporate fixed investment picked up markedly in the reforms year, while inventory rates declined. Overall, the private sector investment increased in four of the first five year of reforms till 1995-96, when it touched a peak of 9.6 per cent, but it declined in each of the year, thereafter to reach 5.9 per cent of GDP in 2000-01. Even after this drop the sector's investment rate is distinctly higher than the pre-reforms year.
2. **Mujumdar (2003)** had evaluated the financial sector reforms. He described three paradoxes, first the banking system is highly liquid, and the paradox is that because of this excess liquidity, banks are chasing prime borrower in the corporate sector. According to second paradox the share of priority sectors in the total credit has declined significantly. The third paradox is the avowed objective of the RBI is to reduce the Statutory Liquidity Ratio (SLR) to 25 percent; banks are

voluntarily investing a substantial part of resources in the government securities. This mountain of surplus securities stands as monuments of inefficient banking, which is in a way a direct result of the reforms package. Bank resources are being siphoned off from productive sector to promote government consumption.

3. **Jha and Rath (2003)** have explained endogeneity of money multiplier in India and variation in it due to financial reforms. The money multiplier has risen to 3.27 in the 1990s from 3.10 in the 1980s. In the 1990s India witnessed significant capital inflow as a result of reforms.

Rate of interest and investment

The abolition of the prescribed minimum rate of banks for large borrowers, announced by Dr.Rangrajan, Governor of RBI on October 8, 1994 is hailed as a land mark in the monetary history of India. It certainly epitomizes the success in moving the banking system away from a highly regulated interest rate regime to a market related rate regime and RBI deserves to be commended for the success. It was expected that decreasing in lending rates will encourage the investment in the economy. Lending rates exhibited the declining trend after 1995-96, but could not attract the investment due to opposite behavior of real lending rate. Investment is following the increasing trend in real rate of interest. But it was following the nominal rate of interest during 1999-2000, when it started increasing continuously and kept on increasing till the starting of recession in 2007-08. Except some cases in early reform era investment has not been following any rate of interest. During 2010-11 even negative real rate of interest could not attract the investment.

Trend in Nominal & Real lending:

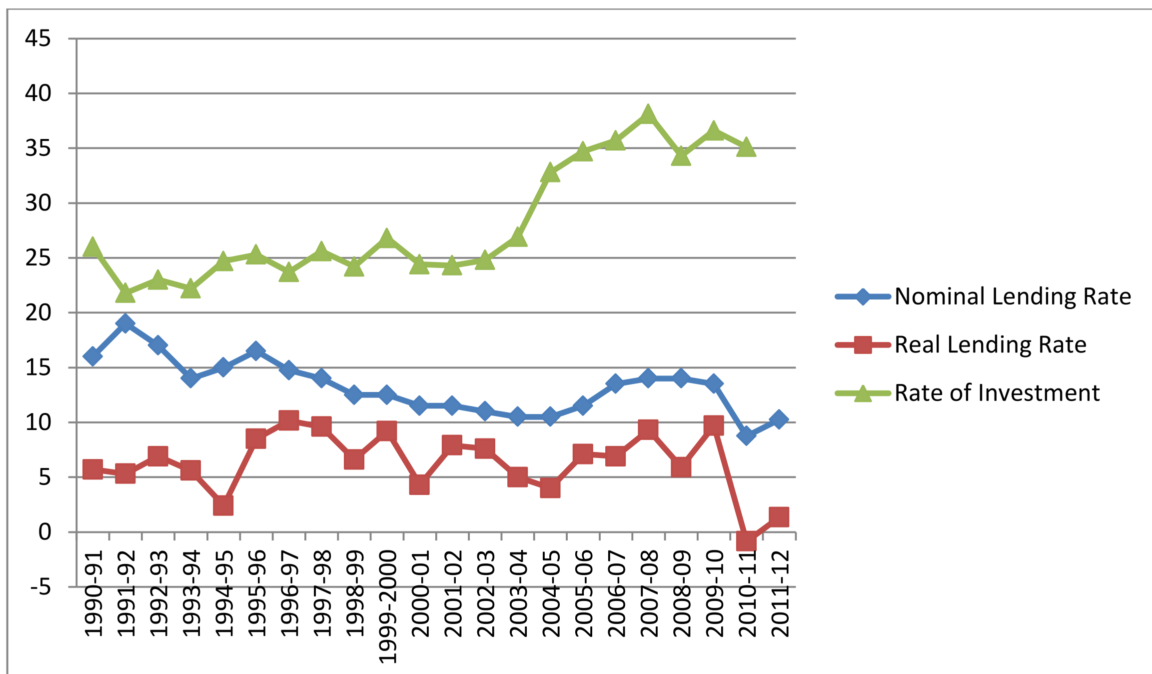


Figure 1.1: Rate of Investment, Nominal & Real Lending Rates

Deregulation of lending rate for big borrowers resulted unhealthy competition among banks, which were ready to provide loans to MNCs on 9% rate of interest but expecting 12% from poor farmers. Big part of liquidity of banks had been transferred to Government due to high yield on Government Securities. Lack of consistency among policies had been there; even then Indian financial system can be counted among strong financial systems and can digest these right or wrong policies. It is working well in global integrated economy.

Money Supply and Credit Growth

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 (Fig-1.3). Growth of credit creation also exhibited sudden decline (Fig-1.4). After the recovery same is happening during 1995-96 and 1996-97 again.

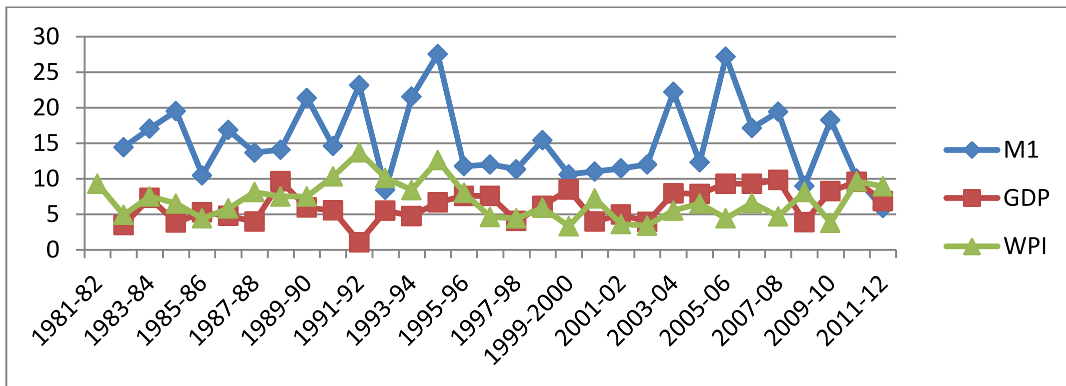


Figure 1.2: Growth of M1, GDP and WPI

Banks create money through credit creation, cheap monetary policy was adopted during the post reform era, but there is no clear effect on growth of credit seen. It was expected to increase at increasing rate but many times it had been declining in the post reform era. Ratio of credit to the total deposits has been decreasing except some fluctuations. Deregulation of interest rate and cheap monetary policy could not support the growth of credit.
If we compare the credit to commercial sector and government sector, growth of credit to government has been relatively higher many times.

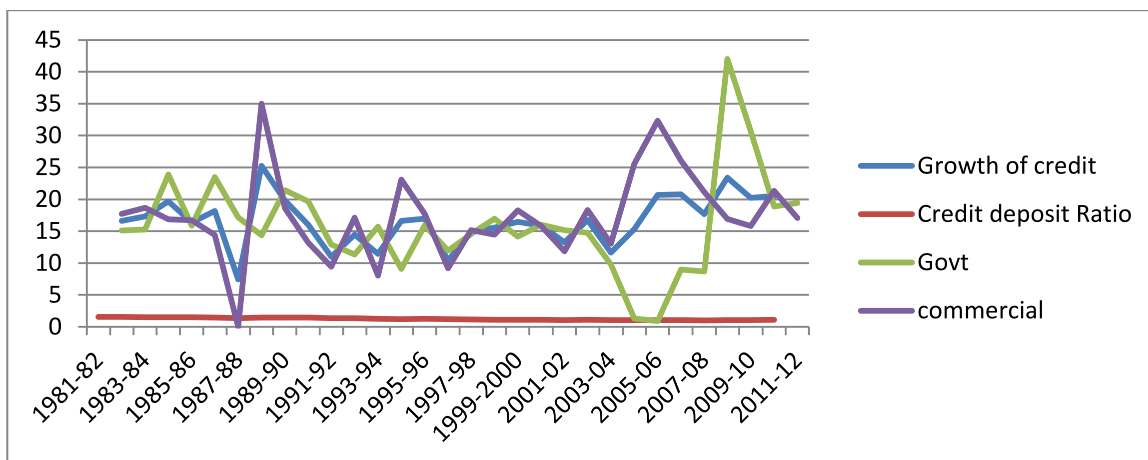


Figure 1.3: Credit Related

Investment in Government Securities has been safest option for banks. There is minimum risk in Government Securities. Risk has always a positive relation with return on a security. Various other investment options are also there with high return. But it is important for banks to keep the solvency in mind, while investing excess reserves

It is sake of solvency, for which banks have been investing their excess reserves in Government Securities even with a low return. But

situation has changed in post-liberalization period, now Government Securities have become an option of high return with high safety.

Very high yield on Government Securities had been matter of debate among monetarists and it should have been. Bank rate had been decreasing and yield on Government Securities had been increasing. Many times during post-reforms period, yield on Government Securities had been higher than bank rate. It was gain without pain for banks to borrow from RBI and invest in Government Securities.

Here we can see ratio of investment in Government Securities to aggregate deposit; it had been higher during post-reforms period. A serious consequence of increasing yield on Government securities had been higher investment in Government securities even after a reduction in SLR. For instance, though incremental statutory liquidity ratio (SLR) has been 25% since September 1993, banks' incremental investment in Government securities was as high as 33.3% in 1993-94 (N.A Mujumdar).

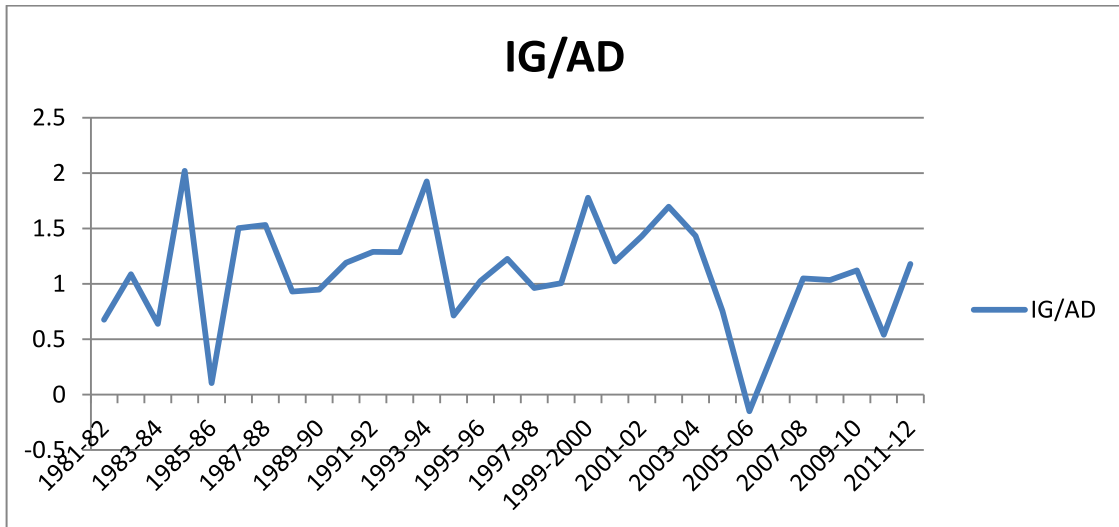


Figure 1.4: IG/AD

We can conclude that low growth rate of credit was due to more and more investment in Government Securities by banks. 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.

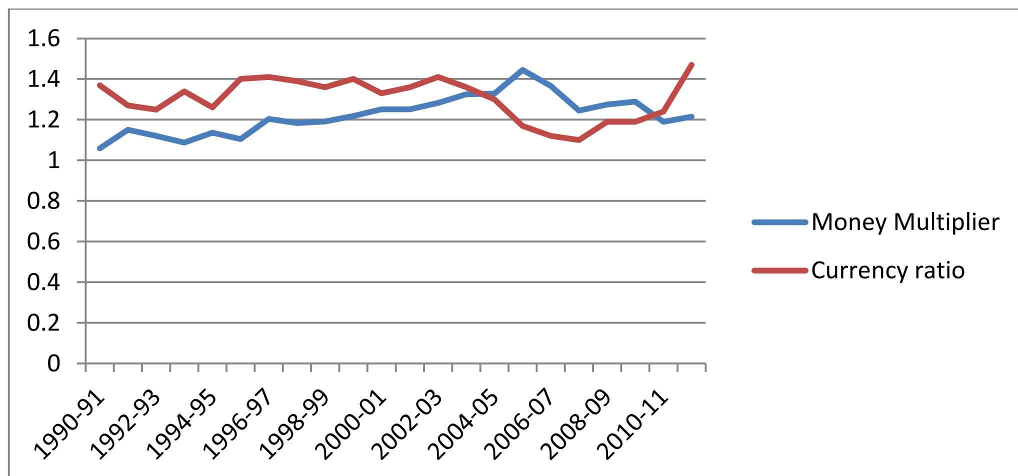


Figure 1.5: MM and Currency Ratio

Value of money multiplier fluctuates with change in currency ratio. Currency ratio is ratio of currency with non-bank public to demand deposits with banks. This ratio is determined largely by non-bank public. Currency ratio is negatively related to value of money multiplier. Rise in currency ratio decreases the value of money multiplier and vice-versa.

High currency ratio means distribution of reserve money is in favor of non-bank public and it affects ability of credit creation by banks. Currency ratio is being affected by some factors; terms of accepting deposits by banks, banking habits etc. Currency ratio is denoted as

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

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

Currency ratio reflects the banking habits of people of the economy also. More use of currency means less developed banking habits of people. After the liberalization number of banks increased to a huge number, still currency ratio had been high. We can see currency ratio had been exhibiting a decreasing trend from 2001 to 2008 but remained more than unitary. It started increasing again.

In the Indian context, as per the Census of 2001, the ratio of demand deposit accounts as per data available as on March 31, 2004 is to the total adult population was only 59% as is found in Coverage of Banking Services. India Currently has a total of 74, 505 ATM of which 66.42 % are owned by public sector & 31.74% by private sector Banks with a total of 227 million debit cards issued but still there is a long road ahead for this sector which is full of challenges & as well as opportunities.

Foreign Banks

Foreign Banks have their registered head offices in a foreign country but are operating by their branches in India. The RBI has permitted these banks to operate either through branches or through wholly-owned subsidiaries. But foreign banks operating in India have to follow all banking rules and regulations such as priority-sector lending norms as applicable to domestic banks. Increasing entries of foreign banks in India in the mid-90s and the increased presence of foreign banks in India has also boosted competition. There were total of 33 foreign banks with 316 offices across India as expressed by - Profile of Indian Banks, RBI 2011. Citibank was the largest Foreign Bank in India followed by Standard Chartered.

Non-Performing Assets

We can define NPA as any advance where payment of interest or repayment of instalment of the principal, as in case of term loans or both remains unpaid for a certain period. Though in India, the definition of NPAs has changed over time. As per the Narasimham Committee Report in 1991, all those assets as advances, overdrafts, bills discounted, cash credit etc. for which the interest is remaining unpaid for a period of four quarters or for 180 days should be considered as NPAs. But later on from March 1995 this period was reduced and now any assets for which the interest has remained unpaid for 90 days only would be considered as NPAs. Debt Recovery Tribunals were established on the basis of the recommendations of Tiwari and the Narasimham Committees, in various parts of the country. An Asset Reconstruction Company was established and various other measures were also taken to reduce NPAs such as corporate debt restructuring rescheduling and restructuring of banks, and recovery through Lok Adalats, Civil Courts, Debt Recovery Tribunals and compromise settlement along with some legal reforms were introduced to speed up recovery.

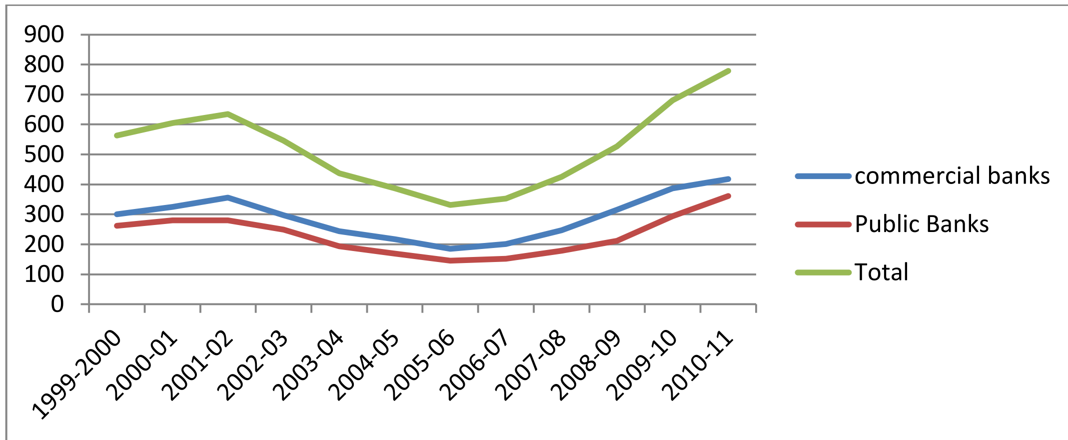
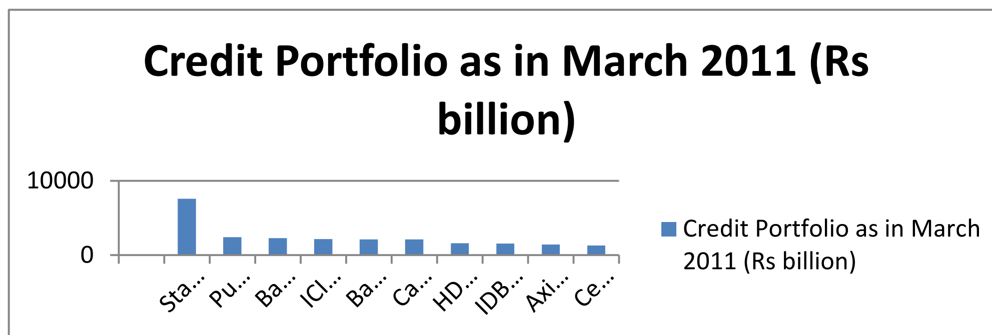


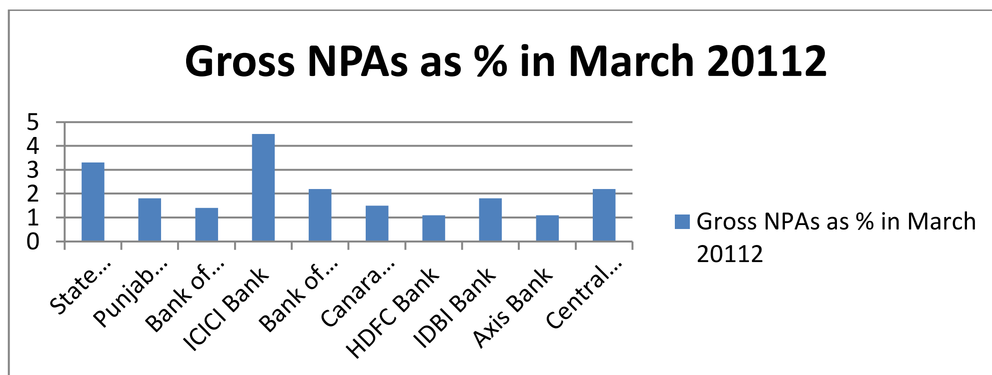
Figure 1.6: Banks Related

Trends in NPAs are shown in figure-1.7.2002-03 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.

Some Recent trends (NPAs) in India Ten Largest Banks



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



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

Conclusion

Money supply and credit creation by banks was expected to increase and provide lubrication to growing business activities. Though GDP growth has decreased immediately after the adoption of liberalization, growth of money supply and credit creation also exhibited declining trends many time after the liberalization. Interest rate was expected to decrease after the liberalization, though nominal interest rate were declining after 1995-96 but hardly mattered for rate of investment. Many time even with decrease in nominal interest rate, real rate of interest increased due to downwards fluctuation of inflation rate. Investment in govt. securities due to increasing yield exhibited increasing trends, credit to government sector many time exceeded to that of commercial sector. These are signs of diverting resources from productive sector to government. Even after announcing cheap monetary policy credit deposit ratio also exhibiting decreasing trends, which is a question mark on competitiveness of 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. Money multiplier after showing somewhat increasing trends started declining after 1995-96. Currency ratio which is important component of money multiplier also reflect the banking habits of people with the more use of demand deposits than currency is a good sign but no declining trends could be seen in 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 in NPAs hiked. Amount of NPAs is more in commercial banks as compare to that of in public sector banks. Present study call for further study compare present scenario after reforms with the post one.

References

[1] Jha R. and Rath D.P. (2003),"On the Endogeneity of the Money Multiplier in India",Indian Economic Reforms,Jha ed.Mecmillion.
[2] Mujumdar N.A. (2003),"Financial Sector Reforms and India's Economic Development",Vol-1., Academic Foundation
[3] Sagar,M.(2003), "Saving, Investment and Macro Economic Policies in the 1990" in Indian Economic Reform
[4] Vasudevean A.(1977),"The Ratio of Currency to Demand Deposits in India, 1951-52 to 1974-75.Reserve Bank of India Bulletin, Bombay.
[5] Rangrajan C.(2002),"Economic Reformss:An Assessment. The Indian Economic Journal, Vol.49, No1, pp.1-10.
[6] Report on Currency and Finance, various issues.
[7] Trends and progress of banking in India, various issues.
[8] Statistical Tables related to Banks of India.
[9] Economic Survey of India, various issues. Govt. of India.
[10] Indian Public Finance Statistics. Ministry of finance/various issues.
[11] Hand book of statistics on Indian economy , RBI publication (Year 2011-12)