Outlook

56. Considerable progress has been made in the implementation of measures designed to improve the financial sector performance. The SLR has been reduced to 25 per cent on the lines recommended by the Narasimham Committee. However, the CRR at 10.0 per cent is above the level to be attained on the lines recommended by the Narasinmham Committee. The macro-economic compulsions in the wake of volatility in the foreign exchange market resulted in a package of measures to protect the Rupee from speculative pressures. These measures, including hike in CRR to 10.5 per cent and Bank Rate to 11 per cent, had tightened the liquidity situation in the economy. Nevertheless, there is no reason to believe that these measures have reversed the medium-term transition to a low interest rate regime signalled by the earlier reduction in Bank Rate. This is borne out by the subsequent reduction in the Bank Rate and the CRR effected in March and April,1998. The growth in bank deposits remains strong and banks are therefore expected to face little difficulty in meeting the credit requirements of the productive sectors .

57. Despite the significant achievements in terms of functional and geographical coverage, our banking system needs to go a long way to become internationally competitive. This requires measures to raise financial performance and secure higher efficiency gains. The experience of countries in East and South East Asia has underscored the importance of stronger and more robust financial system, especially the banking system, to handle the new risks of globalisation. In an open economy, capital inflows assume significance and they tend to raise the deposit base of the banking system.The resulting increase in liquidity with the banking system,if wrongly channeled into less liquid long term investment,can lead to serious asset-liability mismatch.This problem may be exacerbated by asset price fluctuations and currency mismatch.In the absence of deep,liquid and mature debt market,global recycling of funds can to some extent involve two way flows of capital. Capital account convertibility ,therefore, pre-supposes a sound banking system capable of handling risks inherent in globalisation.Keeping in view the need for further liberlisation the Narasimham Committee on Banking Sector Reform was set up in December,1997. This Committee's terms of reference included review of progress in reforms in the banking sector over the past six years, charting of a programme of banking sector reforms required to make the Indian banking system more robust and internationally competitive and framing of detailed recommendations in regard to banking policy covering institutional, supervisory, legislative and technological dimensions. As mentioned earlier the Committee has since submitted its report and the Monetary and Credit Policy for the first half of 1998-99 has indicated further strengthening of existing capital adequacy, income recognition and provisioning norms in the light of the Committee's recommendations.

58. With increasing integration between different segments of financial markets facilitated by liberalisation, the conduct of monetary and credit policy has become critical for the efficient functioning of the financial system. In India, monetary policy has to be evaluated in an integrated framework based on the inter-relationships among money supply, interest rate, exchange rate, credit output and prices. The changes in output and prices have exhibited wide variations over time. Studies have shown that acceleration in inflation broadly coincided with acceleration in monetary expansion. As noted in the previous Economic Survey, economic policy instruments act on economic system with a lag. Besides, very short-run problems may call for measures which may appear to be at variance with medium/long term policy objectives.

59. Recent years have witnessed a blurring of the traditional distinction between banks and financial institutions. In keeping with this development, there has also been relaxation in project financing norms for infrastructure lending by banks. Similarly, banks have been allowed to have two-tier PLR—one for working capital and loans up to three years and the other for loans exceeding three years. In this context, the recommendations of the Working Group set up by the RBI for harmonising the role and operations of DFIs and Banks and the RBI initiative to prepare draft proposals on the respective roles of banks and financial institutions, as announced in the monetary and credit policy for the first-half of 1998-99, also assume significance. These developments, however, fall short of measures needed to facilitate financing of infrastructure projects. In view of long gestation period,infrastructure projects require funds with long maturity, which can be provided by Insurance and Provident Funds. The financial savings of

households held by these institutions are long term liabilities which can be converted into long term assets. Further steps aimed at developing the domestic debt market should be designed to facilitate the flow of contractual savings for infrastructure financing.