Next Generation Financial Reforms for India

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A new report advocates a shake-up in India's financial system to underpin growth

INDIA has grown by leaps and bounds in recent years and is emerging as a major world economic power. After lumbering along at a pace of about 4–5 percent GDP growth a year in the 1980s and the 1990s, the economy has surged in this decade, posting an average annual growth of 8.5 percent since 2005 (see Chart 1). The challenge now is to maintain this growth momentum and provide benefits as well as economic opportunities to a broad swath of the population.

India's financial system—comprising its banks, equity markets, bond markets, and myriad other financial institutions—is a crucial determinant of the country's future growth trajectory. The financial system's ability to channel domestic savings and foreign capital into productive investment and to provide financial services—such as payments, savings, insurance, and pensions—to a vast majority of households will influence economic as well as social stability.

While India's financial institutions and regulatory structures have been developing gradually, the time has come to make a more concerted push toward the next generation of financial reforms. A growing and increasingly complex market-oriented economy, and its greater integration with global trade and finance, will require deeper, more efficient, and well-regulated financial markets.

A shopping mall in eastern India.

These considerations prompted the Indian government to institute a high-level committee—composed of a select group of financial sector practitioners, businesspeople, academics, and policymakers—to map out a blueprint for financial reforms. After more than six months of intensive work, the committee recently delivered its draft report to the government (available at *http://planningcommission.nic.in/reports/genrep/report_fr.htm*). In this article, we summarize the key findings of the report and examine its recommendations.

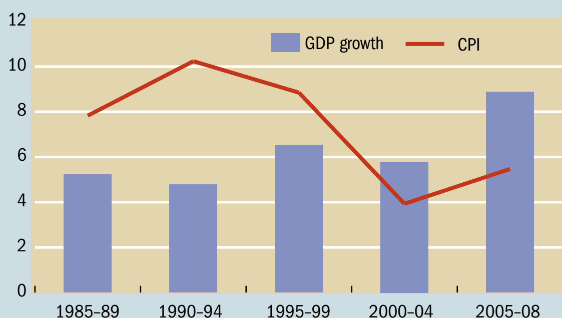
Three main conclusions

Numerous other government committees over the years have looked into specific aspects of India's financial reforms, but this is the first committee mandated to "outline a comprehensive agenda for the evolution of the financial sector." Indeed, the report argues that there are deep linkages among different reforms, including broader reforms to monetary and fiscal policies, and recognizing these linkages is essential to achieve real progress.

Chart 1

Nice combination

Until recently, India has seen strong growth coupled with moderate inflation during the current decade, although now prices are climbing rapidly again.

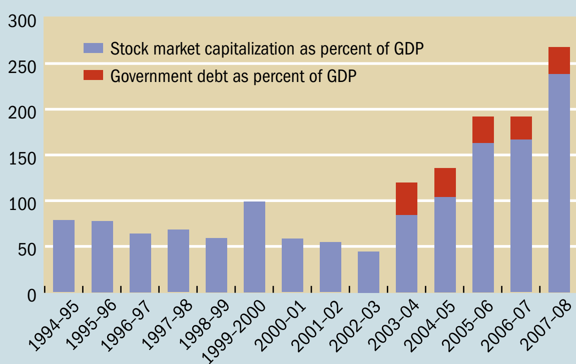


Sources: CEIC; IMF, *International Financial Statistics*; and authors' calculations.

Chart 2

Equity boom

The rapid expansion of India's stock markets has helped fuel corporate growth, but debt markets remain small.



Sources: CEIC; and authors' calculations.

Note: Only publicly traded government debt is included in this chart (breakdown not available before 2003–04). Corporate debt barely shows up on this scale, so we do not include it here. India reports its macroeconomic data on a financial year rather than calendar year basis.

The report has three main conclusions. First, India's financial system is not providing adequate services to the majority of domestic retail customers, small and medium-sized enterprises, or large corporations. Government ownership of 70 percent of the banking system and hindrances to the development of corporate debt and derivatives markets have stunted financial development. This will inevitably become a barrier to high growth.

Second, the financial sector—if properly regulated but unleashed from government strictures that have stifled the development of certain markets and kept others from becoming competitive and efficient—has the potential to generate millions of much-needed jobs and, more important, have an enormous multiplier effect on economic growth.

Third, in these uncertain times, financial stability is more important than ever to keep growth from being derailed by shocks hitting the system, especially from abroad. Although the Indian economy dodged the Asian crisis and the recent subprime crisis, a lot remains to be done to secure the stability and durability of the financial system.

Where things stand

The report finds that the Indian financial system has made significant strides in recent years. India's stock exchanges, in particular, have developed well and become a vital source of funding for enterprises and an alternative savings instrument for households. Stock market capitalization has risen significantly—aided by financial inflows from abroad—and the technical infrastructure of equity trading is state of the art (see Chart 2).

The Indian government has taken a number of steps to improve the banking system. Banking reforms, which started nearly two decades ago, have increased the efficiency of the banking system, and the ratio of nonperforming loans to deposits is about 1 percent—a remarkably low level. Many of the public sector banks have become quite profitable and well capitalized, and they coexist with a vibrant private banking system.

However, in terms of overall financial depth—the size of the financial system relative to the economy—India does not compare favorably with other countries or even most other emerging markets at a similar stage of development. Despite the apparent strength of the banking system, the ratio of private sector credit to GDP is still low by international standards (see Chart 3). Some of the restrictions on the banking system, and the incentives for banks to hold government bonds rather than make loans, have stifled lending. Consequently, the average ratio of loans to deposits in the Indian banking system is much lower than in most other countries.

The government bond market appears large—public debt amounts to about 70 percent of GDP—but much of the stock of government bonds is held by banks, a requirement pre-

scribed by the "statutory liquidity ratio," and is not traded. The corporate bond market remains woefully underdeveloped, with the total capitalization amounting to less than 10 percent of GDP. Regulatory restrictions have also kept certain derivatives markets, especially for currency derivatives, from developing.

The absence of these markets is being felt sorely as India's capital account has become more open over time, potentially leading to greater short-term currency volatility. India is seen as an attractive destination for foreign capital, which has meant large inflows in recent years through various channels, especially portfolio equity investment by foreign investors (see Chart 4). The financial system faces ever-greater challenges in intermediating the rising amounts of foreign as well as domestic capital in an efficient way to the most productive investments. At the same time, it will be important not to let the capacity and expertise to regulate financial markets fall too far behind innovations in these markets.

Clearly, there are big challenges to achieving further financial reforms. Let us start with the big picture.

Fine-tuning macroeconomic policies

Why do macroeconomic policies matter for financial reforms? The links between macroeconomic management and financial development are deep and run in both directions. Disciplined and predictable monetary, fiscal, and debt management policies create a foundation for financial sector reforms. In turn, a well-functioning financial system is essential for the effective transmission of macroeconomic policies.

Whatever their faults might be, India's macroeconomic policies have delivered high growth and, until recently, stable inflation. Why fix what ain't broke? Because, in the memorable words of Bob Dylan, the times they are a-changin'.

Cross-border capital flows—both inward and outward—have ramped up and are likely to remain large and volatile, creating huge complications for monetary policy as these flows affect the domestic money supply, the exchange rate, and so on. Reimposing capital controls is not a good option; even existing controls are losing their potency as agile investors invariably find ways to evade them. The only viable alternative is to have predictable and consistent policies that at least do not create volatility themselves and that give policymakers the flexibility to respond rapidly to shocks.

What are the options for monetary policy, especially now that the demands on it are growing as the economy becomes more open and exposed to a wider array of domestic and external shocks? The Reserve Bank of India (RBI), India's central bank, has done a good job of managing the multiple mandates foisted upon it—keeping inflation under reasonable control, managing some of the pressures on the exchange rate, and coping with capital inflows—all against the background of strong growth. But there is a risk that this highwire act has reached its limits. The recent volatility in the rupee has revived calls for the RBI to more actively manage the exchange rate, which is becoming increasingly difficult as the capital account becomes more open. Sustained intervention in the foreign exchange market can also create unrealistic expectations about the RBI's ability to manage multiple objectives with one instrument.

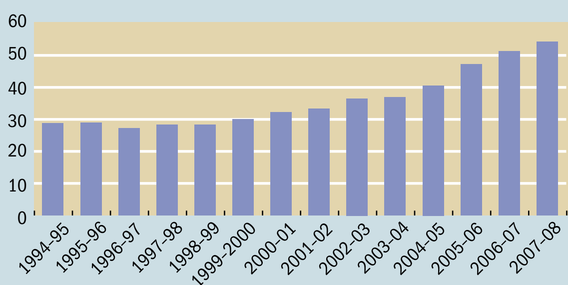
Focusing on a single objective—low and stable inflation—is ultimately the best way that monetary policy can promote macroeconomic and financial stability. This does not mean sacrificing or ignoring growth. Indeed, well-

Chart 3

Under potential

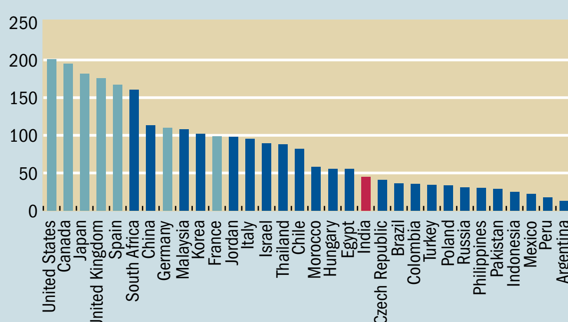
Bank financing has been rising in India . . .

(private sector credit to GDP, percent)



. . . but financial depth remains low by international standards.

(private sector credit to GDP, percent, 2006)



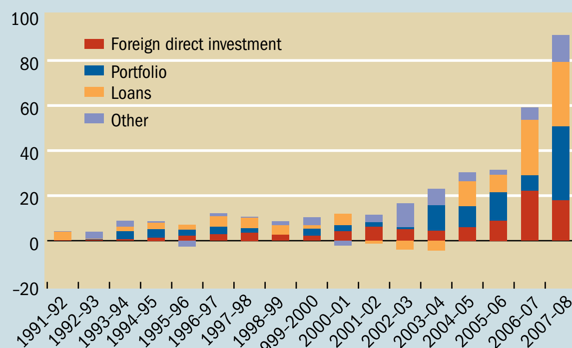
Source: World Bank, *World Development Indicators*.

Chart 4

Pouring in

India is attracting large amounts of portfolio investment from abroad.

(billion dollars)



Sources: CEIC; and authors' calculations.

anchored inflationary expectations may well be the best tonic that monetary policy can provide for growth. Contrary to what some commentators seem to believe, there is no long-run trade-off between growth and inflation, and for monetary policy to try and engineer a short-run trade-off can be dangerous. In short, the inflation objective would in fact make monetary policy more effective and strengthen the RBI's hands rather than pinning them down.

India's fiscal policy also needs a makeover. There has been encouraging progress in reducing the budget deficit, but this may just be a cyclical improvement as a result of a strong economy. Recent events, such as the government's waiver of certain farm loans and the growing oil subsidies, raise serious concerns that fiscal rectitude may fall prey to the election cycle. Large deficits raise the specter of future inflation, and they could also suck up funds that would otherwise be available for private investment.

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The size of government budget deficits matters for financial reforms also because the deficit is partially financed by getting banks to buy government bonds. Durable reductions in the fiscal deficit and public sector borrowing requirement are therefore crucial to reduce the constraints on monetary policy (as prospects of large deficits make it harder to manage inflationary expectations) and allow financial sector reforms, especially banking reforms, to proceed.

Promoting financial inclusion

A robust financial system is not much good if most people don't have access to it. Financial inclusion—which means providing not just credit but also other financial services such as savings and insurance products—is a key priority, especially in rural India. Nearly three-quarters of farm households have no access to formal sources of credit and lack instruments to insure against adverse events such as low crop yields due to bad weather. But this problem is not limited to rural areas. The lack of access to formal banking services affects more than one-third of poor households, leaving them vulnerable to informal intermediaries such as moneylenders, and makes the distribution of public transfers less efficient. And the lack of financing and insurance stifles entrepreneurial activities.

Mandated requirements of a certain quantum of lending to government-favored "priority" sectors and interest rate ceilings for small loans, especially to the agricultural sector, may be well intentioned but have ended up restricting rather than improving broad access to institutional finance. Banks have no incentive to expand lending if the price of small loans is fixed by fiat. Partly as a consequence, nearly half of the loans taken by those in the bottom quarter of the income distribution are from informal lenders at an interest rate of more than 36 percent a year, well above the mandated lending rate for banks, which is less than half that rate.

According to the report, the solution is not more intervention but more competition between formal and informal financial institutions and fewer strictures on the former. For instance, freeing up interest rates and then setting up incentives for banks to make loans to priority sectors such as agriculture (rather than just mandating this by fiat) could lead to more credit flowing to these sectors and in a more efficient way. Allowing more banks, especially smaller, well-capitalized and well-governed private banks, to operate and deliver retail services could also improve access to finance—making it more flexible and more attuned to local needs.

A level playing field

Given the size of the Indian banking system and its predominant role in the financial system, banking reforms are a cornerstone of the overall reform program. The Indian banking system has been characterized by an implicit "grand bargain," whereby banks get access to low-cost deposits in return for fulfilling certain social obligations, such as lending to priority sectors and funding the government by buying government bonds. This is becoming an unviable framework as the privileges of banks, including state-owned banks, erode and constraints on them such as priority sector lending, which are often motivated by political rather than economic considerations, increase.

Maintaining public ownership of a large portion of the banking system is not conducive to efficiency. A one-shot privatization is not realistic or even desirable, but there is a lot that can be done even now to facilitate the transition to a more efficient banking system. One step would be to create stronger and more independent boards, perhaps with a private investor owning a large strategic stake, that could manage the large state-owned banks better and with less government interference. Another would be to allow bank mergers, especially to enable smaller and less efficient banks to be taken over. Other steps, such as freeing up banks to set up branches and ATMs with less onerous licensing restrictions, could foster more growth, entry, and competition in the banking system.

Keeping regulation in step with innovation

The U.S. subprime problem has highlighted the need for good regulation even in the most sophisticated financial markets. Effective regulation is still more important in a nascent but fast-growing financial system. The government has an essential role: making the rules of the game clear and flexible enough to cope with financial innovation without stifling it.

For instance, fostering markets for foreign exchange derivatives would help domestic firms with exposure to international trade protect themselves from currency fluctuations. But it does create some risks that foreign investors will use those markets for mounting speculative runs on the currency and that domestic firms will get burned if they buy those derivatives without fully understanding them. The solution is not to choke off these markets but to make them more transparent, subject participants to uniform disclosure standards, and prevent fraudulent behavior. Can all risks be eliminated? Certainly not, but there are definitely ways to shift the balance between benefits and risks in favor of the former.

As in many other countries, a number of financial services firms in India now operate in different financial markets (for example, insurance, banking, and mutual funds), and these markets are becoming more closely linked. These trends imply that regulation of each market in isolation is no longer the right approach. The situation right now is that there are multiple regulators in some areas and none in others. Many regulators for specific areas tend to focus very narrowly, leaving financial firms unsupervised.

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Although a move to a single regulator may be premature in India's context, a lot can be done even within the present framework to improve coordination and to clearly delineate responsibilities among existing regulatory agencies. Also, instead of focusing excessively on enforcing a plethora of sometimes archaic rules, it certainly makes sense for regulators to focus on the bigger risk picture, especially in their interaction with large, systemically important, financial conglomerates. Such principles-based regulation will be more conducive to rapidly evolving financial markets and is also more adaptable.

The potential risks of a financial meltdown have made central bankers and regulators very cautious, perhaps rightly so. But excessive caution is not a virtue in itself. It can prevent markets from becoming larger and capable of absorbing shocks, and stifle innovation such as the development of new markets and financial instruments. It could even generate more financial stress (and have perverse effects when such stress does hit the system) if regulators focus on a rigid set of rules rather than taking a broader view of financial market exposures of institutions under their purview.

Connections and small steps

With so many difficult challenges, where does one start? Many of the required reforms are in fact deeply intertwined. For instance, it would make sense to level the playing field between banks and nonbank financial corporations by easing the requirement that banks finance priority sectors and the government. But making these changes while the government continues to have huge financing needs, and without having a more uniform and nimble regulatory regime, could be risky.

The connections stretch beyond just financial reforms to broader macroeconomic reforms, which could reinforce individual financial sector measures. For instance, allowing foreign investors to participate more freely in corporate and government debt markets could increase liquidity in those markets, provide financing for infrastructure investment, and reduce public debt financing through banks. It could also provide an additional risk-bearing buffer in the economy.

India's rich and complex political process being what it is, focusing solely on the big picture could bog down progress. Hence, the report also lists a number of specific steps that could get the process of reforms going and build up some momentum as people see the benefits. Many of these are less controversial but will still require some resolve on the part of policymakers to implement. For instance, converting trade receivable claims to electronic format and creating a structure to allow them to be sold as commercial paper could greatly boost the credit available to small and medium-sized enterprises.

We believe that if other policies are in sync, implementation of this report's blueprint for financial sector reforms could add significantly to India's economic growth and also make a major contribution to the sustainability of this growth, in both the economic and the political dimensions. The absence of reforms, on the other hand, would represent not only a lost opportunity but also a huge source of risk for the economy. ■

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Other members of the team who contributed to the report include Rajesh Chakrabarti (Indian School of Business), Vinay D'Costa (ICICI Bank), Ajay Shah (NIPFP, New Delhi), Professor Jayanth Varma (IIM Ahmedabad), and Sona Varma (ICICI Bank). The full listing of the members of the committee and all contributors appears in the preface to the report.