Chapter – V

Financial Sector Development and Growth : Issues and Options

5.1 Introduction

It appears all variants of reform ideologies are obsessed with the concept of equilibrium interest rate.[1] The rate they believe reflects true scarcity of capital. Incantation of neo-liberalists "rely on market determined equilibrium interest rate" for efficient mobilization and allocation of resources shaped policy decisions of many less developed countries (LDCs). The countries now consider repressed financial system failed to keep its promises – thus its an excess baggage, a dogma that can only be accepted at the cost of slower growth of economy. In sum, what can be recognized is that from early 1970's the demise of Keynesian approach (low interest rates on bank loans and deposits promote investment and growth: Keynes 1936, Jorgenson 1967) was accompanied by a rise in the growth theory what has been termed as financial Liberalisation approach.

Advocacies of this new ideology (McKinnon 1973 and Shaw 1973) along with a large body of researchers (Fry 1978, 1982, Jung 1986, Thorton 1990, King and Levine 1993, Calderon and Liu 2003) dedicated themselves to prove efficiency of free market to maximize economic welfare. Briefly, theory proposes – raising interest rates to market clearing level increases willingness of people to save, thus more loans available to investors, hence equilibrium rate of investment increases. Thus neo-classical theorists dumped many of the conventional wisdom of Keynesian philosophy as obsolete, awfully inadequate to explain the intricate relationship between finance and development.

But the concepts of 'equilibrium interest rate', 'competitive financial system', 'less intervention more efficiency' and examination of other components of transmission mechanism suggested by McKinnon and Shaw delivered contradictory evidences. Both pro and anti liberalisation theorists can usually find enough support to prove their cases. Some of these formidable criticisms finally inspired McKinnon(1989) to revisit the concept and they finally settled for a more pragmatic approach of restrained financial Liberalisation.

All these criticisms, however, do not imply that financial repression does not matter, of course, it does. But we emphasize that there is the need to refurbish and reformulate the neo-

[1] The concept of equilibrium interest rate is ill defined; grossly it may be treated as rate of interest that equilibrates savings and investment in the financial system.

classical approach to accommodate the criticisms made against it, so as to develop a more correct, sensible and enlighten policy capable to support much needed change process of LDCs.

We propose to review the policy of "less intervention and more development" for an economy that is plagued by demand crisis, less than fuller capacity utilization and excess liquidity – ills that are conspicuously prevalent in Indian economy. We refrain from making any detailed analysis of the reasons – interventionists or changed policy environment contributed in the present state of unwarranted economic development. But, would prefer to focus on the theme, if financial system matters for development – does continuation of present policy of financial Liberalisation can help us to treat effectively the ills of Indian economy, if not, are we the victim of 'doctor is the disease' syndrome ? Is it realistic to assume that private initiative coupled with some enlightened state intervention can help to meet more effective the problem of excess liquidity of our country? Is there any scope for public authorities to influence or suspend the operation of market forces to deal efficiently the problems of Macro-economic management? The issue that is now continuously being explored by Rakshit (2005), Marjit (2005) and others.

5.2 Supply and Demand for Funds under Full Capacity Utilisation

Ignoring peripheral aspects of the theory of financial Liberalisation we summarize some essential features of McKinnon – Shaw hypothesis below:

On savings – investment and efficiency:

Shaw (1973) opines that indiscriminate 'distortions of financial prices including interest rates and foreign exchange rates' in the control regime 'has stopped or gravely retarded the development of LDCs'. Thus much discussed alternative development strategy suggested by McKinnon and Shaw asks developing economy to go beyond the policy of 'intervention' and to rely on market to decide interest on savings and investment. Very succinctly, theory of financial liberalisation suggests, market determined higher interest rates – increases incentives to save, invest and raises the average efficiency of investment', hence economic welfare. Theorists also promise market-centric approach with all possibilities usher efficiency and stability of financial system by encouraging competition, risk reduction by diversification etc.

On elasticity of demand :

Second major assumption of neo-classical approach most relevant for present thesis is – growth in financially repressed economy is constrained by savings, investment opportunity is abound (McKinnon 1973, Shaw 1973). This is how liberalist perceive major impediment of LDCs economic development. Thus the theorists obvious conclusion is rise in real interest rate would help to accumulate more savings and demand of money for investment would absorb all the funds

without any scope of credit rationing. The policy suggestion essentially implies 'demand deficiency' does not matter; growth of economy is sub-optimal due to non availability of investible resources.

On compulsory credit allocation:

Third assumption, a direct off shoot of second is, when investment opportunity is plentiful, 'wasteful and inefficient' compulsory credit allocation retard the growth of more 'efficient and rewarding' private investment. Hence compulsory credit allocation has a social cost. It arrests the growth of private sector by shifting resources from risky production input with higher expected return to safe and less risky investment that would affect adversely long term growth of the economy (See Obstfeld, 1994), virtually, economy suffers doubly: misallocation of resource and compulsory reserve induced higher cost of borrowing and increased production cost. In a sense loanable fund theory deflates Keynesian paradigm as detrimental to investment and growth.

Besides efficiency loss, government taxation as neo-structuralist argue, contribute in the development of informal credit market that is free from reserve requirement to satisfy ever increasing money demand (McKinnon, 1973). Presumably, underlying assumption of the theory is – control regime encourages to enjoy monopoly power by imposing numerous restrictions (licensing, import etc.) and allow firms to enjoy high profit regardless of cost. In the competitive economic environment, firms to minimize cost and to meet growing domestic and foreign demand will try to use its capacity to its fullest extent; hence demand for money will increase (Azeez, 1999, Bhagawati and Srinivasan 1975). Reserve requirement, that re-rout the fund from private to government sector will to an extent deprive the economy from enjoying the benefit of this transition process.

For long, all of these assumptions are under close scrutiny of serious researchers, but for the present writing we would prefer to re-examine the relevancy of these assumptions in the framework of the present crisis of Indian economy.

Growth in the financially repressed economy is constrained by saving: investment opportunities abound. Whole concept is elaborated in the diagram shown below.

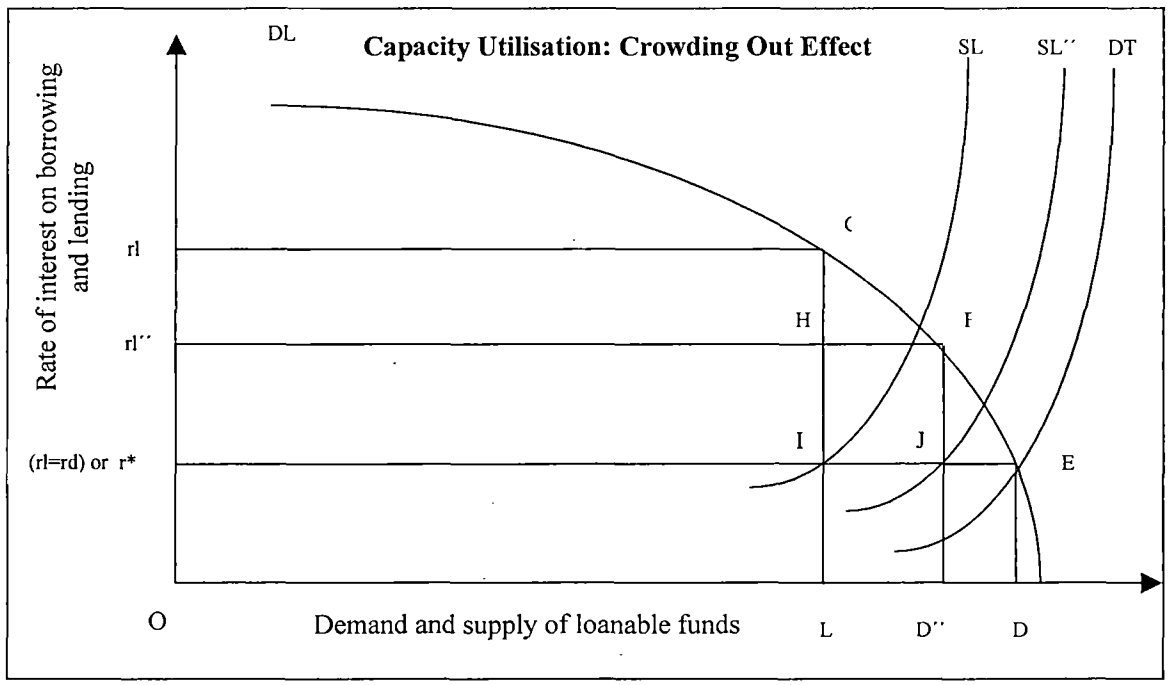

Fig 5.2.1

The diagram shows, how the reduction of SLR and CRR affect the supply of loanable funds to corporate sector, movement of real lending rate and in sum, the concept of much discussed crowding in and crowding out paradigm.

In the above figure downward sloping (DL) curve is demand for loanable fund which is inversely related with real lending rate (rl). While upward sloping demand for time deposit curve (DT) positively related with real deposit rate. In the vertical axis we measure real deposit rate (rd) and real lending rates (rl). Horizontal axis shows the supply and demand for loanable funds with constraints of reserve requirement. We define reserve, as compulsory deposit with central bank along with all sorts of government directed low or negligible interest bearing investment that taxed financial system and which has social cost. At point E, demand for loanable fund equalizes supply, where rd equals to rl and total amount of fund demanded and supplied is OD. It's the situation of 'pareto-efficiency, where interest rate r* is such determine that it is not possible to someone better off without making someone worse off [See Besley 1994]. Equilibrium point is E. Whether this 'ideal' situation is achievable or even desirable to aspire is the subject of an unending debate (McKinnon 1993, Stiglitz 1994, Agrawal 2004) which is beyond the purview of our present study. We are precisely interested to reflect how government taxation large rations out a proportion of potentially high yielding investments (Fry 1982).

Now in the above diagram, supply of loanable fund (SL) is determined after setting aside reserve requirement K, i.e., SL = (1-K) DT. After making provision of LD amount of fund, OL amount of fund is available for corporate sector investment, while demand for fund is OD. As a result some otherwise good investment project would be rationed out and real lending rate will reach to rl as demand for fund exceeds available supply. This is what much discussed "crowding out" effect is. Now a cut in K would result a shift of SL curve right word to SL'', and LD'' amount of extra fund would be available to the market and real lending rate will drop to rl''. In the presence of effective demand for investment LD'' amount of extra fund (which were crowded out earlier) will be available for high yielding, technologically advance risky project.

The theory influences policy decision of many countries and by now reduction of reserve requirement is a global trend and India is also no exception. In some highly developed economy it is zero even (e.g., U.K., Canada, Sweden, Australia, Newzeland etc.).

Table 5.2.1: Reduction of Cash Reserve Ratio and Statutory Liquidity Ratio

Year	CRR %	SLR %	Total
1	*2*	*3*	*(2+3)*
1990-1991	15.00	38.50	53.50
1994-1995	14.00	33.75	47.75
1998-1999	9.00	25.00	34.00
1999-2000	8.50	25.00	33.50
2000-2001	5.50	25.00	30.50
2001-2002	5.00	25.00	30.00
2002-2003	4.50	25.00	29.50
2003-2004	4.50	25.00	29.50

Source: Reserve Bank of India, various issues.

In this extreme situation, central bank follows a somewhat different but questionable monetary policy to control 'inflation – stabilization' objective without creating undue allocative 'distortions' across sector of the economy (Woodford 2003). Under the given situation, profitability as a measure of efficiency and riskiness of bank portfolio may be shown as follows :

$$R_{BP} = \frac{W_1 \overline{R}_P}{\sigma_{RP}} + W_2 \overline{R}_f \ldots\ldots\ldots\ldots (i)$$

Where $\overline{R}_P > \overline{R}_f$ and $\sigma_{RP} > 0$, $\sigma_{Rf} \Rightarrow 0$

Where R_{BP} = Return on bank portfolio, W_1 and W_2 are weight of bank portfolio invested in private sector and government sector respectively. $\overline{R}_p$ = average return for investment in private sector, $\overline{R}_f$ = average return for investment in risk free government securities.

Thus by definition every reduction in reserve requirement would maximize "efficiency" of banking sector measured in terms of profit along with its risks – where $\sigma_{RP} > \sigma_{Rf}$. Undeniably it's a crude measure of risk that ignores covariance of return (interest, non traditional and non-interest income) among the assets of a diversified bank portfolio even more robust studies of Stiroh (2002), Smith and Wood (2002) attest our analysis that diversification of bank portfolio contributes in profitability at the expense of higher risk.

Economists are often accused of not agreeing with others and the debate on various assumptions of neoclassical approach further support the views. But recent studies (Rakshit 2005, Marjit 2005) based on Indian experiences; provoke us to assume that this paradigm failed to keep its promises to meet the demand crisis that the country is facing nearly for a decade. Thus we believe that the assumption of self regulated financial system that the "markets clear so that full employment of resources is attained" (Rangarajan and Srivastava 2005) deserves serious scrutiny based on our past experiences and conceptions about future before ruling out totally Keynesian view "investment or consumption, financed by government borrowing would cause output to expand through a multiplier process" (See Rangarajan and Srivastava 2005). While developing an alternative strategy that centre on growth, the case of stability, equity along with the problem of output gap to be considered with equal importance.

5.3 Excess Capacity: Irrelevance of Crowding out Theory

Is there any relevance of the theory of capital rationing for an economy that is victim of recessionary condition thereby excess capacity since mid 1990s ? In fact, there was an investment boom in Indian industries in mid 1990's, while investment boom raised production capacities substantially, but Uchikawa (2001, 2002), Goldar and Kumari (2003), argue that demand did not rise which led to capacity underutilization. Under the given situation, is it reasonable to assume that reserve or any form of government taxation has a social cost as acclaimed by liberalist? What form of government intervention can rescue banks from the problem of excess liquidity due to inadequate demand of investible resources by private sector, yet help to maintain macro economic

stability? How a public-private partnership can help our economy to successfully dodge 'demand crisis' to achieve the target of full employment?[2]

While discussing above questions, we will attempt to prove that the core policy prescriptions of the votaries of liberalisation theorists — savings as the ultimate determinant of growth is incredibly inadequate to capture the complexities of the current problem of our country. Ignoring peripheral issues, we spell out some macroeconomic features (from mid 90's to 2003) of our country to further our discussions — (a) fall in average GDP from 7.5 to 4.7 percent (b) Decline in overall and public sector investment rates by 2.2 and 1.9 percentage points respectively (c) Fall in current account deficit (excess of domestic investment over domestic savings from 1.4 to – 0.2 percentage points).

Typical Savings – Investment Behaviour of Indian Economy

Responsiveness of savings to interest rate changes in LDCs is an extensively researched topic and at the end empirical evidences fail to suggest any concrete results in favour of this paradigm Deatons (1990, 1992) model of precautionary saving behaviour of credit constrained, low income, multigenerational households virtually deflates the dogma of orthodoxy that "higher the real interest more the savings". Along with it, our own analysis (see earlier chapter) also suggests that not interest but level of income influences savings and rise in income is only feasible by proper employment of unutilized resources. Thus we posit, savings function i.e., 'demand for time deposit' is nearly inelastic to change in interest rate. If the present policy of 'rely on real interest rate' continues savings target of 2010 may not be achievable.

Problems mentioned not escaped attention of policy makers that is evident from repeated assertions that there is a need to bring "potential output closer to full employment level, saving rate of household sector to be achieved 10% by 2010", 'manage public finance to ensure 'stability', debt reduction along with equitable growth' (See Report of Twelfth Finance Commission). But the policy prescriptions largely rely on 'restructuring of interest rate and institutional development bereft of any solid, sensible suggestions on demand management. Thus the suggestion is based on a week theoretical and empirical foundation that assumes causation of growth runs from savings, investment and growth. Presumption that surely defies the reality of an

[2] RBI study along with twelfth finance commission report refers to the prevalence of excess capacity in India since mid 90's. Lack of effective demand and its policy implications have been studied in details in the report of the commission. For a Brilliant review of the said report see M. Rakshit (2005).

economy where excess liquidity and suboptimal utilization of capacity is the main impediment of growth[3]

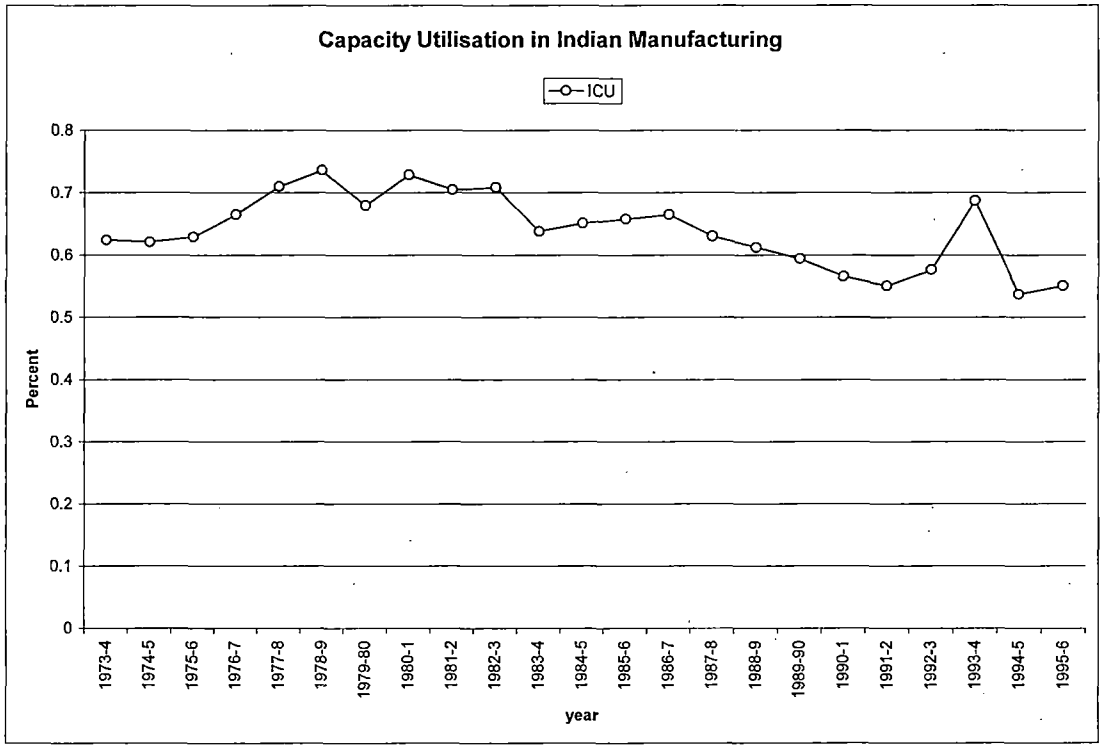

Fig 5.3.2

Widely held orthodox view further suggests – faster the financial assets accumulation lesser the intermediation cost, more efficiency gain due to competition, decrease' in wasteful credit programme will usher in more funds available for private investment at cheaper cost, finally economy will follow a faster growth path. Implicit assumption is, opening up of the economy will contribute in demand bonanza (Azeez, 1999) and increased supply of fund will be immediately absorbed to ensure improved capacity utilization and full employment.

When supply of funds are abound, gap between potential and actual capacity utilization gradually contributing skepticism among economists (Rakshit 2004, 2005, Marjit 2005, Bagchi et.al. 2002), who now believe that the money-supply led growth strategy is indefensible either in theory or in practice.

Thus we propose to calibrate a model of investment function for an economy where the demand for investible resources is less sensitive to lending rate but more responsive to investment

[3] Within this general framework, sector wise variation of capacity utilization and demand for money may of course vary. This theory perfectly describes Indian scenario – where slow down in investment is followed by encouraging growth of IT sector

opportunity.[4] It essentially implies any discussion on investment behaviour that solely rely on interest rate ignoring other macro economic variables such as income, consumption pattern, distribution of income is inherently incomplete. Hence, reformists find it difficult to explain why potential investments do not permit to absorb all savings of the economy.

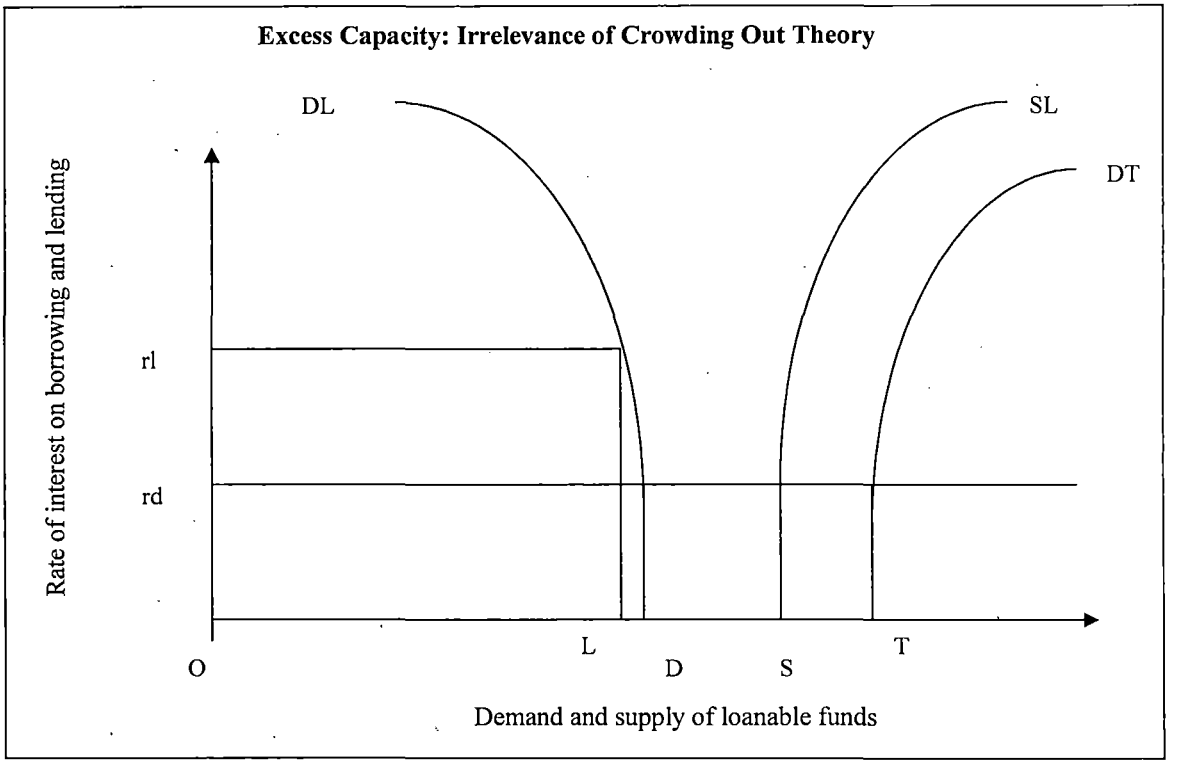

Fig 5.3.3

Thus both savings and investment behaviour in our model deviates widely from the basic assumption of neo-classical theory. At rD level of interest deposit available with the bank is OT level. After setting aside ST amount of fund for reserve, OS amount of funds released for market demand. Assuming money demand is nearly in elastic even at rD level of lending rate (a case of pareto optimal efficiency) demand for loanable fund is OD. It is a case where supply and demand for funds are not self equilibrating as it has been assumed by theorists. Virtually DS amount of fund remains a begging as there is no mechanism through which additional money balances could be used for extending loans to prospective private investors (Rakshit 1994).

The situation is much more complicated than it appears if one takes into cognizance state of competitiveness of Indian banking system.

[4] IDBI sponsored project at the centre for studies in social science shows that interest rate does not explain investment, cash flow does.

Table: 5.3.2: Concentration Indicators, 1993-2000

M-Bank Concentration Ratio	1993	1996	2000
1 bank CR (SBI)	24.7	22.2	24.2
5 bank CR	50.2	47.4	48.1
10 bank CR	65.4	65.5	65.0
Herfindahal index			
All	11.2	7.2	7.0
FB	14.1	11.9	12.2
PV	11.3	5.8	5.2
PSB	15.1	9.8	10.1

Source: Sayuri Shirai,P. Rajasekaran (KEIO SFC journal Vol. 1 No. 1 2002)

Competition the core of neo-classical theory is essentially limited in many LDCs-including India, despite opening up of banking sector for private investment (George R.G.Clarke 2005). Concentration indicators unveils, even after regime shift, there is insignificant change in competitiveness in banking sector in India[5]. Liberalist view competition as a virtue that leads to 'constructive destruction', while critics (See Agrawal 2004) ascribe excessive competition as a vice that causes destruction of civil society which many LDCs faced in recent time. Ignoring the debate, we prefer to note that Indian experiences like many other developing economies challenge the basic tenet of liberalisation theory.

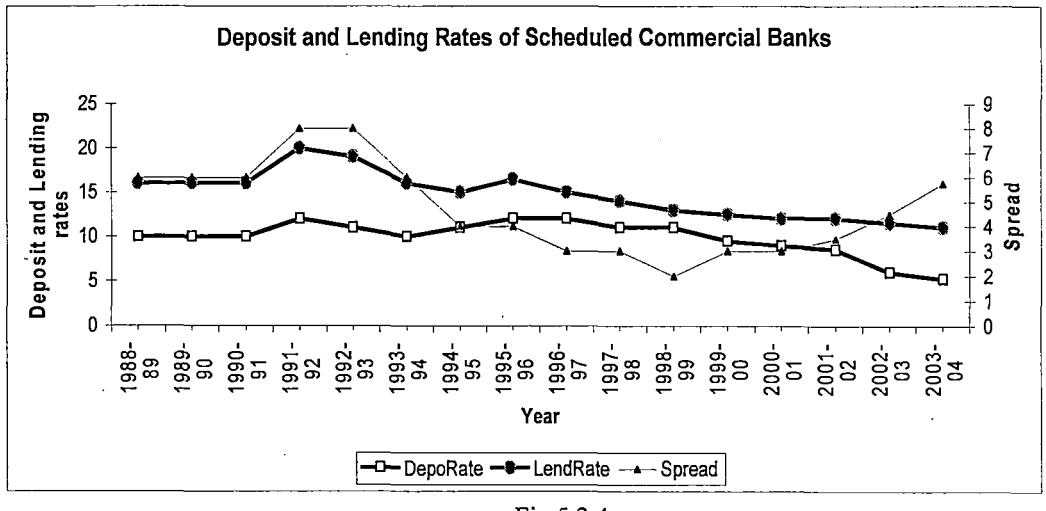

Fig 5.3.4

[5] Bank merger is now constantly enjoying the blessing of our policy makers, who like many other mainstream economists believe that it is desirable on the ground of economies of scale and scope. Though many researchers expressed their reservation about this allege benefit but univocally opined that such measures would surely contribute in market concentration (See Bagchi and Banerjee 2005, Dymski Gary 1999).

Another apparently ridiculous feature of Indian banking is – low demand for funds with high spread. This rising gap particularly from close of 1990's among others implies limited competition that allows banks to enjoy the freedom to regulate interest rate that necessarily may not be market clearing rates (Scholnick 1996). This spread of course includes essence of 'mild financial repression' suggested by Stiglitz (1994) and finally accommodate by McKinnon in his thesis along with prevailing opportunity of squeezing borrower of the specialized market that the bank serves.

When lending rate is rl, demand for loanable funds further declines to OL level, leaving unutilized funds to the extent of LS. Hence bank investment in government security exceeds than what is required and theory of so called "crowding out" of private investment appears as a fallacy. (Marjit 2004).

Table 5.3.3: Credit Deposit Ratio and Investment Deposit Ratio of Scheduled Commercial Banks

Year	C/D Ratio	I/D Ratio (Investment in Govt. Securities)	Total I/D ratio
1	2	3	4
1990-1991	64.70	26.00	39.00
1994-1995	58.90	30.40	38.50
1998-1999	56.80	31.20	35.60
1999-2000	55.30	34.20	37.90
2000-2001	54.80	35.30	38.90
2001-2002	56.00	35.90	48.89
2002-2003	56.70	39.56	51.17
2003-2004	55.80	43.52	50.92

Sources: Economic Survey. RBI bulletin, various years

With limited scope of productive investment a change in the dynamics of bank portfolio becomes inevitable and this reallocation of fund has a spontaneous impact an economic growth. The analysis will help to realize how banks are responding to some unforeseen development in the post liberalisation period to sustain in this unique environment. Hence, risk-return relationship of bank portfolio may be summarized as follows:

$$TR = \left[\frac{W_1 \overline{R}_P}{\sigma_{RP}} + W_2 \overline{R}_f\right] + \frac{\overline{NII}}{\sigma_{NII}} \quad \ldots\ldots\ldots\ldots (ii)$$

Here, TR i.e., totals return of the bank consisting of two parts. First part is interest income (x) on bank portfolio and second part (y) is non-interest income NII; which is mainly fees and commissions income that results from scale and scope of banking system. In the first part, $\overline{R}_p$ is

the average return from private investment (interest on loan, advances and non SLR investment) $\overline{R}_f$ is average return from government securities which is risk free, W_1 and W_2 are their relative weightage. σ_{RP} And σ_{NII} are average risks of private investment and non interest income, where for all cases $\sigma_{Rf} \Rightarrow 0$.

We assume under full employment, $\sigma_{RP} > 0$, $W_1 > W_2$ $R_P > R_f$, $\sigma_{NII} > 0$; In case of under utilization of capacity $W_2 > W_1$, other things remain same. Strictly from economic point of view, theorists claim that $W_1 > W_2$ is a better option than $W_2 > W_1$, the state of solution that is at the core of free market theory but unattainable by many developing economies due to lack of potential investment opportunities. Thus countries have to settle, what liberalists claim as a 'low order policy'.

So called 'low order policy' however ensuring a stable banking system in our country. Nevertheless, a true measurement of risk of bank portfolio must take into account the nature of variability of interest income and non-interest income. Modern portfolio theory suggests not the standard deviation $(\sigma_x + \sigma_y)$, but the covariance (Cov_{xy}) i.e., r_{xy} is the true measure of risk. In the developed economies this two flows generally remain positively correlated (Stiroh 2002) that implies the risk of bank earning is $(\sigma_R > \sigma_x + \sigma_y)$, where as in India, these too stream of income are mostly negatively correlated that satisfies the essential condition of Markowitz theory.

Table 5.3.4: Variability of Interest Income and Non-Interest Income 1994-2004

Particulars	Interest income asset ratio	Non interest income asset-ratio	Corr. Between Int. non interest
SBI Group	6.18	10.90	- 0.25
Nationlised Banks	5.73	10.87	- 0.80
Private Sector Banks	17.99	23.07	- 0.19
Foreign Banks	7.10	46.01	- 0.63
SCBs	6.10	11.29	- 0.75

Source: Report on Trend and Progress of Banking in India, 2003-04.

Furthermore higher investment in government securities contributing in a stable banking though it may not satisfy the condition of higher profitability. Nevertheless, stability helps to

maintain steady inflation, interest rate, employment all the objectives that policy makers aspire to achieve along with a desire for rapid economic growth in terms of productive investment and targeted GDP.

Table 5.3.5: Select Balance Sheet Indicator of SCBs

Year	Share of interest income as percent of total interest income		Stability : Indian Banking	
	On loan/advances	Interest on investment	CRAR Above 10% (as percent of total no. of banks	Percentage of NPA in total advances
1997	57.3	36.2	64	17.84
1998	52.0	41.0	69	16.02
1999	49.0	42.0	72	15.89
2000	48.0	44.5	83	14.02
2001	45.5	44.0	84	12.02
2002	47.2	45.0	89	11.09
2003	48.7	44.4	95	9.14
2004	N.A.	N.A.	97	7.58

Source: RBI Bulletin various years.
* N.A.: Not available

At the bottom, when demand and supply of funds for private investment are not self equilibrating, it may be viewed as a symptomatic of the failure of new-classical theory. Thus Indian policy makers will have to go beyond the cliché that non-availability of adequate funds is the basic of slow growth of our economy. Instead there is a need to change the focus on effective demand management that will finally lead to higher investment and growth. Before acclaiming that 'reserve is wasteful', it has a 'social cost' merit of government spending to be adjudged in the perspective of its ability to improve capacity utilization.

5.4 Excess Capacity : Government Borrowing and Spending

Reducing capital expenditure is an undesirable proposition as it may depress private investment and reduce aggregate demand. However, we refrain from entering in any detailed discussion on whether expansionary or contractionary fiscal measure can bail out our economy from the current crisis. There is a consensus that any policy on generation of revenue, tax reform, and restructuring of custom duty to lower the supply of government debt to create space for the

private sector (See Pinto and Zahir 2004) is a misdirected policy that may adversely affect public consumption and private disposable income (Rakshit 2005). So where there is an output gap, government should go for large scale infrastructural investment to get rid of demand crisis and to encourage private investment (Rangarajan and Srivastava 2005).

For the purpose of present study it is proposed that cost and benefit of government spending in India to be examined in the context of our central theme that shrinking demand prevents firm from using its potentiality to the full extent. All the insights provided by neo-classical theorists that reserve has a social cost looses its significance if central banks make proper use of reserves so as to counter demand deficiency. The issue is especially important when (G) government debt does not directly crowd out private (I) investment.

Change in government debt to GDP ratio can be divided into two parts : one is primary deficit to GDP ratio another is real interest rate paid on government debt and growth rate of real GDP. The change over time of government debt (Δ GD) may be explained by following equation

$$\Delta GD = PD_t + ffd_t + \frac{(r_t - g_t)}{(1 + g_t)} GD_{t-1} \quad \ldots\ldots\ldots\ldots \text{(iii)}$$

Where ΔGD = Change in government debt to GDP i.e., $(GD_t - GD_{t-1})$

PD_t = Primary deficit to GDP

ffd_t = New flow of debt net off disinvestment (privatization receipt) to GDP.

r = Real interest rate on government debt

g = Real growth rate of GDP

t = Time period

Impact of expansionary fiscal policy on inflation, interest rate, savings, investment along with the issue of sustainability to be scrutinized in the perspective of cost of government borrowing (r) and growth of the economy (g). Thus the intricate relationship between r and g is our primary focus of attention.[6]

In the context of full employment, deficit may lead to crowding out of private investment. Thus in many developed economies it is maintained at level zero under normal condition. (See Rangarajan and Srivastava 2005). But in India, where demand for loanable fund is insufficient to absorb the available savings, can we propose that the present stage of budget deficit and excess government pre-emption is essentially bad as argued by neo-classical theorists ?

[6] For a discussion of similar nature see Goyal, 2004.

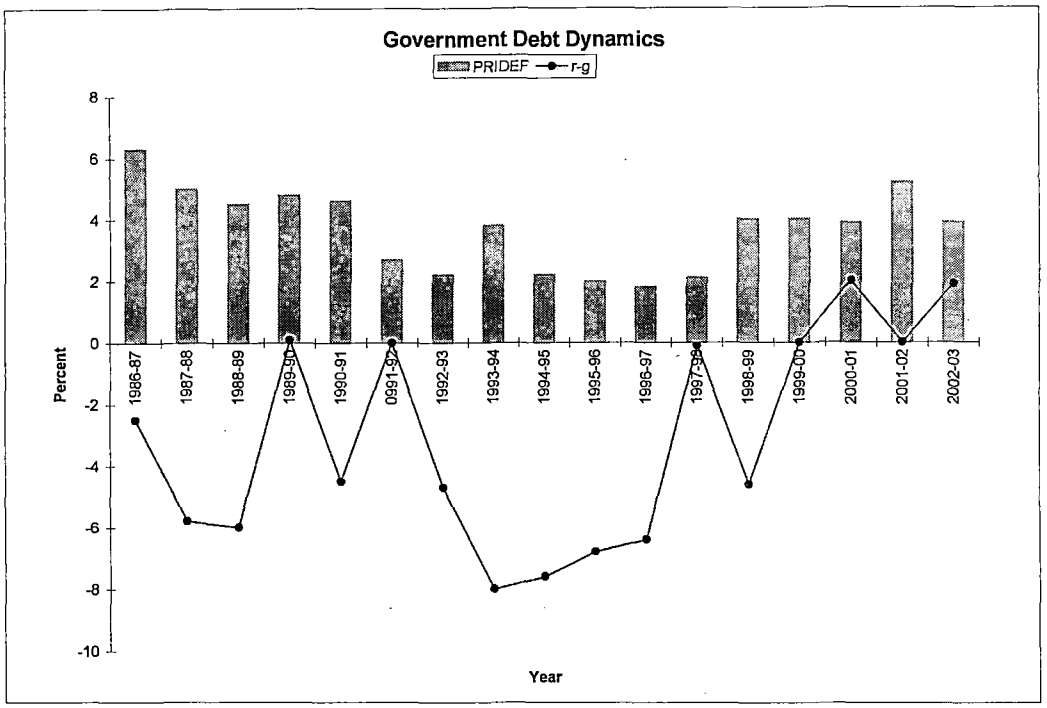

Fig 5.4.5

Implied (r-g) has charted an upward trend after 1994-95 and has been either close to zero or positive since 1999-2000, despite of record low interest rate over the last two decades. This may be attributed to the fall in investment demand in the private corporate sector and rise in volume of debt as liberalisation progressed.

It is of course an unwarranted situation; it cannot or should not be allowed to continue for long. But policy to be developed aiming long term effect and one should not emphasize simply on current experiences as spending is mostly financed by long term debt. It's not any attempt to fain any logic that undermine the importance of increasing marginal productivity of government spending as pointed out by R.B.I. But we affirm that policy of better demand management to be pursued.

Our macro-economic condition is much more stable than many of its counterparts in terms of low inflation, no default, no debt restructuring and high international liquidity (Pinto and Zahir 2004)[7]. In this context, policy decision to be guided by the fact that in the absence of

[7] Financial sector bailout cost has not as far been significant unlike East Asia and some of the transition countries of Central and Eastern Europe. Since 1992-93 relatively small amounts of funds have been spent by our government to assist nationlised banks, Regional rural bank, UTI, IDBI and IFCI.

opportunity of private investment, social marginal productivity of government investment remain higher hence desirable.

We propose, when there is an output gap, the government should go for large scale long term investment programme and when there is an excess demand and inflationary pressure, and government should rely on other contractionary fiscal measure along with monetary squeeze without scaling down its long term investment (Rakshit 2005).

Conclusion

Different national financial systems are made of different institutions and arrangements, with different conceptions of the future and assessment of past experiences and thus operate with different modalities of calculation. This is at the core of our writings; we tried to prescribe some policies most suitable for an economy where not savings but absence of effective demand is seriously arresting the growth of economy. Issue of "repression" and liberalisation of financial system role of the government, fiscal policy all have been analyzed dispassionately simply from the perspective of some typical features of our economy i.e., underutilization of potential capacity, excess liquidity along with a stable macroeconomic condition of our country. All the policy prescriptions that have already been mentioned in the text aim to achieve full employment. Conjoint impact of excess liquidity, problem of demand for private credit, issues related to the intermediation of banking system on development of financial system and its economic implication is the subject matter of our next chapter.

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