CHAPTER – I

Introduction

1.1 Prelude

Objective of rapid economic development can be achieved in any economy only if there is a stable, vibrant, innovative and efficient financial system capable to support ever changing needs of the society. Less developed economy reckoned this fact only in early 1980's.[1] Why development of financial sector is an essential ingredient for growth of the economy? The issue has been extensively researched by Schumpeter (1911), Goldsmith (1969), McKinnon (1973), Shaw (1973), King and Levine (1993), Demirguc-Kunt and Levine (1999) etc , who finally concluded that an efficient financial system can only mobilize and allocate resources to most desirable and productive form of investment that contribute in capital formation and growth. Theorists further emphasized as real income and wealth increases, size and complexity of the financial superstructure also grows. Thus the financial systems of most rapidly growing economies are usually deeper because savings rate of those countries are higher than slower growing economies.

There is a debate, among economists, between mobilization and allocation of savings, which one is most important for less developed economy.

Some commentators believed that differences in living standards among countries primarily reflect the efficiency with which resources have been and are being used. Prime among the factors influencing income levels and growth rates is how productively saving has been used, even more than how much was saved. This is reflected in the fact that over the last quarter century the average growth rates of developing countries have been more highly correlated with the productivity of investment than with the rate of investment. Higher income countries have succeeded in allocating their savings to more productive investments than have lower income countries. This has many reasons but paramount among them are the methods by which the allocations of savings were determined (See World Development Report 1989).

An attempt is made in the next section to critically review, what the state of Indian financial system was in the era of centralized planning. Very specifically the next section will deal with the following issues: What was the structure of Indian financial system during control regime? What was the problem with the government controlled financial system? What factors

[1] During 1970's, favourable terms of trade and cheap foreign funding enabled developing countries to finance investment expenditure despite the small size of their financial system.

motivated our policy makers to deregulate this system? All these issues are very important and have a direct bearing on the subject matter of the present study that deals with the topic financial liberalisation and its development implications.

1.2 Financial Liberalisation: motivation, issues and objectives

After independence, for more than four decades, we developed a financial system that was truly "repressed" and all the "vices" of such a structure were prominent. During those years government controlled the financial system to regulate the supply of money and credit in a centrally planned economy. Government often balances the budget deficit by money creation. This excessive rate of money creation generally spurt the rate of inflation. Several tools were used by the government to control the monetary aggregate. The major instruments of control were — regulation of interest rates (with various rates on deposits and lending being fixed by the government or central bank), quantitative credit allocation, high reserve requirement, concessional interest rates for specified sectors coupled with subsidization etc. Government directed credit allocation rob the freedom of bank managers over the use of funds, relieve them from accountability, force them to invest in low yielding government securities, indulge in allocation of resources other than for economic reasons, promote corruption that seize creative and innovative ideas of bank managers that result in misallocation of resources and retard growth of the economy. Most probably, among many LDCs, Indian Financial System was the worst victim of excessive government interference (See Table 1.2.1).

Table 1.2.1 : Compulsory Credit Allocation: Experiences of Select LDCs.

Country	Year of advances	Percent of financial system advances
Pakistan	1986	70
Yugoslavia	1986	58
Brazil	1987	70
Turkey	1983	53
India	1988	90

Source: Compiled from World Development Report 1989.

The inevitable consequences were an increasing degree of inefficiency in the whole system leading to erosion of profitability of the banking sector. Much discussed Narasimham Committee Report well documented the pathetic condition of Indian Banking business of that time. Thanks to "no competition" and blessing of the government, banks simply manage to survive with enormous non performing assets[2]. While an efficient financial system can contribute in the growth of the economy by improving productivity of investment, an immature structure conversely can arrest economic growth.

Slowly and gradually, dismal economic growth and macro-economic crisis started engulfing Indian economy – intolerable inflation, unsustainable fiscal and current account deficit, sharp down grading of India's credit rating, unbearable domestic and foreign loans, cut-off of foreign lending were some dreadful features of an economy that was virtually on the verge of collapse(See Table 1.2.2).

Table 1.2.2: Major Macro-economic Indicators: Experiences of Early 1990's.
(1990-91 to 1991-1992)

Change in the Indicators	1990-91	1991-92
GDP (annual % change)	5.4	0.8
Inflation (% p.a. W.P.I.)	10.3	13.3
Broad Money (annual % increase)	15.1	19.3
GDI (% GDP)	27.1	23.6
GDS (% GDP)	23.7	23.1
Real GFCF (% GDP)	21.3	20.3
Of which Public	8.6	8.7
Private	12.7	11.6
Current Account Deficit (% GDP)	3.2	0.4

Source: Joshi and Little 1997.

Immediate drastic action that included a large devaluation deflationary fiscal measures and financial assistance from official donors and lenders were essential to prevent default.[3]

And finally, the bold stroke of disgruntled policy makers was the decision to let loose the economy from state control – popularly known as economic liberalisation. Theme song of the new regime is 'competitive efficiency' that will help India to meet two strategic objectives; eradication of poverty and playing rightful – role in the world by becoming a source of growth and stability for the global economy (Kelkar 2001).

India started its reform programme with twin objectives namely a stabilization programme in the short run and a structural adjustment programme in the medium term. Successes of these two agenda widely depend on financial and fiscal sector reform. Financial sector was correctly ignored from the initial reform process (see Wyplosz, 2001). Following text book model

[2] No Overall figures of NPAs are available in the first half of the 1990's. However, in 1993-95, the public sector banks NPAs rates averaged 22.5% of loans and they accounted for over 80 percent of the system in that period (RBI, 1998).

it swiftly moved at the top of the agenda because deficiencies and weakness of this sector were adversely affecting the change process. A high power committee was set up in August 1991 under the Chairmanship of M. Narasimham, a leading economist and former governor of RBI to suggest the basic framework of financial liberalisation which is an incredibly complex process.

1.3 Scope of the Study

Votaries of the market economy promised that this regime shift would help for better mobilization and allocation of resources that will ensure stability and growth of the economy. Policy makers of our country declared in no uncertain term that the process of liberalisation is "irresistible and irrecoverable".

Critics of the market economy are hesitant to buy the story that "financial liberalisation leads to growth" and forcefully argue that the theory is yet to be tested (Burkett and Dutt, 1991). Problems of asymmetric information, inadequate regulation and supervision, destructive competition, poor law and order situation of many LDCs, may lead to collapse of financial system in the post reform periods (Kaminsky and Reinhart, 1999, Mehrez and Kaufmann, 2000). Critics further argue, even developed economy with all its honest effort for several decade failed to insulate their financial system from the above shortcoming – these countries are still not free from crisis (Wyplosz, 2001). Finally, one of the earlier signatories of market economy, Joseph Stiglitz (2001) now consider financial liberalisation as incredibly intolerable and warned LDCs to accept it at their peril.

The experience of different countries with similar reform programmes has shown a spectrum of results — which ranged from moderately successful to disastrous (see world development report 1989). While in some countries reforms helped in strengthening the financial system, some other has to face the set back.

In the view of these conflicting evidences of several liberalised economies, it is imperative that we critically study the possible impact of financial liberalisation in the development process of our economy.

Thus we hypothesize —

Financial deregulation is essential for better mobilization and allocation of resources thereby growth and development of our economy.

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[3] After 17.38% devaluation of rupee in July 1991, the rupee was pegged again to the US dollars until March 1993 when it was devalued further by 19.2%.

During the process of our study an attempt will be made to answer the following research questions: -

1. What steps have been taken to liberalize Indian financial system? Is it sufficient? What problems our policy makers are facing while liberalizing the financial system?

2. What are the major symptoms we are visualizing in the financial market of our country after liberalisation? Whether experiences of financial liberalisation so far ventured in our country are encouraging or not? More specifically, what is the impact of reform process on savings, investment and growth?

3. On the basis of experiences, is it possible to predict where this regime may lead us? Can we make any blanket statement that government intervention is always undesirable?

The issues are important and its critical analysis will help us to adjudge the possible implications of the regime shift on our economy. In our thesis, we intentionally ignored stock market, one of the most important constituent of any financial system. Theorists often argue capital market which is free from "moral hazard" can allocate resources more efficiently than bank (Cho 1986). However there are enough counter evidences that show consecutive market break around the globe led to enormous sufferings of the economy in terms of plugging currencies, soaring interest rate, mass unemployment, restrained consumption and investment – which pure theory does not endorse. Reason for ignoring stock market from the present study is to make the discussions manageable without undermining its importance in the development of corporate sector.

1.4 Plan of the Thesis

Apart from the current one, the whole work is divided into six interrelated chapters :

1. Second chapter mainly deals with the theory of liberalisation and the steps taken by our government to develop a market oriented financial system.

2. Implications of the regime shift on money market activities are the subject matter of third chapter.

3. Fourth chapter mainly deals with the pattern of movement of interest rate in our country along with testing the hypothesis that increase in real interest rate helps to mobilize more saving thereby investment.

4. Relevance of financial liberalisation theory in an economy characterized by excess liquidity has been thoroughly analysed in the fifth chapter.

5. Sixth chapter attempts to measure state of development of Indian financial system vis-à-vis other developed and developing countries in absolute as well as in relative terms.

6. Finally we summed up our discussions in seventh chapter.

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