CHAPTER – VII

Conclusion and Policy Implications

7.1 Conclusions

During the last one and half decades, numerous measures were initiated to liberalise our financial system. Many of these reforms were introduced in response to the need of the moment rather than as a part of a well articulated strategy. Nevertheless, all these policies were designed to develop an efficient financial system capable to support growth process of economy and the measures virtually marginalized the role of planning commission that performed an important function in the earlier regime. However, this transformation process was gradual which we believe suits well in the context of democratic set up of our country. Now there is a broad consensus among major political parties that this process of financial liberalisation is "irreversible". For policy prescription, now it is the time to take stock about what the policy of liberalisation promised and what it delivered.

Policies that rely on market help immensely for the widening and deepening of our financial system that includes banks, stock market, government security market etc. Array of financial instruments, institutions, rules and regulations that were absent in the control regime, now offering immense services to the supplier of funds. Stupendous growth of treasury bill, call money, CDs-CPs market, stabilization of call and treasury bill yield rate, lower cost of government borrowing, banking efficiency in terms of income, reduction of non-performing assets and finally greater integration of Indian financial system with rest of the world are some encouraging features of this new regime. However, all these development to be evaluated in the context of its impact on growth process.

Our study reveals some interesting features that deserve serious attention of policy makers.

1. <u>On Interest Rate, Savings and Investment</u> :

Advocacies of liberalised financial system suggest that a market determined real interest rate helps to mobilize more savings to be used for productive purpose. It is also acclaimed that investment opportunities are abound, thus the higher savings will be immediately absorbed for private sector investment supporting growth of our economy. But our findings shows :

(a) Following theory of liberalisation, most of the interest rates of our country are market determined and the real rate of interest is higher than the repressed regime but belying the hopes of liberalist's interest rate and savings of our country are not correlated.

(b) After regime shift, there is a decline in growth of household sector savings in financial assets. This trend does not satisfy the claim of liberalists. Along with other studies our own analysis also suggests that not interest but level of income and its distribution influence savings. If the present policy of simply relying on real interest rate continues saving target of the household sector at the rate of 10 percent by 2010 may not be achievable.

(c) Due to demand deficiencies, banks are the victim of excess liquidity and the theory that savings will equilibrate investment does not hold good.

(d) It is argued by the supporter of market economy that liberalisation will boost both internal and external demand for goods and services produced with the opening up of the economy and capacity utilisation will be optimum. But our study suggests that due to demand deficiency, capacity utilisation is far less than optimum.

(e) Nearly indistinguishable yield on long and short term government bond is a typical post reform phenomenon of our country. This does not satisfy the claim of financial economists. Thus government depends more on long than short term funds for its borrowing.

2. <u>On Competitiveness, Efficiency and Bank Autonomy</u> :

Key slogan of market oriented financial system is "more freedom", "greater accountability", "more competition", "increased efficiency". All these virtues of an efficient financial system will lead to higher growth of an economy. It is assumed by the neoclassical theorists, compulsory credit allocation has a social cost, it arrest 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 and limits the autonomy of bank management over allocation of resources. Our study shows :

(a) High spread between borrowing and lending rates suggests we failed to achieve the targets of free market economy in terms of "competitiveness", "efficiency", "cost of capital" etc. Such a high spread implies, our loan market is not efficient in the standard economic sense. Further, high spread results in rise in cost of capital, high prices that reduce real wage, aggregate demand and hence capacity utilisation.

(b) "Repressed deposit rate" and "unchained lending rate" inspiring banks to supply money for non productive assets bereft of "productive assets".

(c) Even after regime shift concentration indicators further unveil that there is insignificant change in the competitiveness of banking sector in our country.

(d) Gradual reduction of SLR and CRR allowing banks to enjoy greater freedom over the allocation of societal resources. Thanks to limited demand of private corporate sector, ironically banks now enjoy little choice over allocation of resources but have to invest their "idle" fund in low yielding government securities that we described as "low order policy", hence the theory of crowding out of private investment is irrelevant in Indian context.

(e) This low order policy followed by banks even after regime shift contributing stability at the cost of profitability, thus instead of relying on market this trend is empowering government over the allocation of resources.

(f) Possibility of bank failure and its related bailout cost is negligible in India in comparison with many other less developed economies.

3. <u>On Fiscal Deficit</u> :

Rise in the cost of government borrowing in the free market economy, reduction in reserve requirement sends a message "discipline fiscal policy' or face the music. Thus the theorists suggest rising interest payments may compel the government to resort to inflationary finance, damaging macroeconomic credibility and raising real interest rate. Thus success of financial liberalisation largely depends on prudent management of public finance. Our study suggests.

(a) Currently cost of government borrowing is at record low level. Booming fiscal deficit, rising market borrowing but dramatic fall in yield on government bond is an interesting finding of our study.

(b) Mounting budget deficit, nearly unbearable government borrowings and high interest burden contributing in greater budget deficit and economy is now truly vulnerable. Experiences of other developing economy that relies on free market is no exception, debt and interest on debt growing at faster rate than does the real economy.

(c) Control of fiscal deficit is possible either by suppressing interest rate or by increasing tax or by the efficient use of borrowed funds so that real growth rate of GDP remains equal to or more than the cost of government borrowing. Despite record low level of interest rate, growth rate of Indian economy from 1999 onwards is either equal to or less than cost of debt. This can not be allowed to continue for long.

4. <u>On Finance and Development</u> :

Neo-classical theorists forcefully argue that financial sector services contribute to economic growth. Our finding shows :

(a) Index score slightly moved upwards after regime shift.

(b) There is virtually no change in the private sector credit (PVCRD) and financial depth (LLY) in the post liberalisation period though these two variables enjoy highest value of co-efficient in the IFD index.

(c) Indian rate of financial sector growth is far behind than many of the fast growing economies.

7.2. Policy Implications

Our attempt to develop a market oriented financial system delivering some results that are awfully frustrating. Decline in the household sectors saving in financial asset, prolonged demand deficit and comparatively inadequate development of financial system are some typical challenges that Indian economy is confronting after regime shift. These outcome may be attributed to our main focus which is in line with the neo-classical theory that savings as the ultimate determinant of growth and presumes that economy stays close to its full employment growth path. Any intervention by government may derail our economy. Thus our policy prescriptions centre around two broad issue :

First and most important for our country, to what extent private initiatives to be supplemented by state intervention to ensure faster growth of the economy. Second, given the structure of financial system, is there any scope for public authorities to influence or suspend the operation of market forces in order to promote saving, investment and allocative efficiency of our system ?

So the reform measures are to be tuned in such a way which can reduce the inequality of income, increases the purchasing power of the people and increase the demand of the product leading to fuller capacity utilisation, employment as well as reduction in cost of production. In an economy, where the theory of crowding out of private investment appears to be irrelevant, government investment involves the use of unemployed resources whose social cost is zero. Under the condition of full employment public investment does not constitute free lunch, its opportunity cost being the foregone private investment. In our country, an increase in current or capital expenditure by the government can go hand in hand with private consumption or investment.

But government expenditure should be restructured in a way that would help to rise in production, open up new investment opportunities for private sector, increase level of employment and thus aggregate demand. Thus we propose.

When there is an output gap, removal of infrastructural bottlenecks should be accorded top priority, it will open up new employment opportunities and facilitate growth of private sector, hence economic development.

Second, in a demand deficient economy, it is investment which drives savings not the other way round. In such an economy, any measure to save more (cut back of government expenditure, rise in taxes) may end up with a fall of income as well as aggregate savings and investment.

Third, demand management policy should take into account temporal shocks or constraints causing underutilised capacity, say, fall in agricultural income may affect industrial demand hence growth of private sector.

A proper macro economic management thus can ensure faster growth of private sector and can contribute in the development of a more active financial system essentially designed to serve private initiative.

7.3. Limitation of the study

Topic of our study is so vast that we failed to scrutinise all the issues immaculately. Agenda of financial liberalisation includes all the financial macro economic objectives viz., price stability, exchange rate stability, balance of payment equilibrium, efficient debt mobilization for all the sectors of the economy, proper balance of public borrowings, prudent taxation system, liquidity, profitability and efficiency of banking sector etc. It is difficult to analyse all these aspects of reform process in one study. So, to make our study meaningful and manageable, we deliberately ignored some vital areas of financial sector. One of the major limitations of our study is, we ignored stock market which is one of the important ingredients of any financial system. Theorists after argue, stock market, which is free from "moral hazard" can allocate resources more efficiently than bank. So, it's an issue of an in depth study which deserve special attention of any serious researchers.