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REFORMS IN THE FINANCIAL SYSTEM AND DEVELOPMENT

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Abstract : The pre-reforms period, i.e, the period from the mind-1960s to the early 1990s was char-asterisked by administered interest rates industrial licensing and controls, dominant public sector, and limited competition. This led to the emergence of an economy characterized by uneconomic and inefficient production systems with high costs. This insufficient allocation and use of recourses resulted in high capital-output ratios. Despite a rise in saving rates, there was greater dependence on aid and assistance from abroad to meet urgent situations. for 40 years , which by any count is a long period, India's growth rate average less then 4 per cent annum, while other less-developing countries achieved a growth rate of over 5 per cent annum. Moreover, countries such as Japan and other East Asian countries were able to catch up with the industrials countries of the west by adopting a market-oriented pattern of industrialization. The Indian government, therefore initiated deregulation in the 1980s by relaxing the entry barrier, removing restrictive clauses in the monopolies and restrictive Trade practices (MRTP) Act, allowing expansion of capacities, encouraging modernization of industries, reducing import restrictions, raising the yield on long term government securities, and taking measures to help the growth of the money market. These measures resulted in a relatively high growth in the second half of the 1980s, but its pace could not be sustained.

INTRODUCTION

In the beginning of the 1990s, an increase in world oil prices due the GULF war coupled with the sharp drop in the remittances of migrant workers in the gulf created a foreign exchange crisis in India. This crisis become aggravated as there was an outflow of foreign currency owing to a fear of default by the Indian government on its external commitments. The roots of the crisis, however, lay in the increasing deficit of the central government and an insular economics strategy that caused persistent macro-economic imbalance. Thus, the task before the government was twofold: to restore macro-economic stability by reducing the fiscal as well as the balance of payments deficit and to complete the process of economic reforms which had been initiated in the 1980s.

The government initiated economic reforms in June 1991 to provide an environment of sustainable growth and stability. Economic reforms were undertaken keeping in view two board objective.

1)Reorientation of the economy from one that was statistic, state-dominated, and highly controlled to one that is market-friendly. In order to achieve this, it was decided to reduce direct controls, physical planning, and trade barriers.

2)Macro-economic stability by substantially reducing fiscal deficits and the governments draft on society's savings.

Both stabilization and the Structural Adjustment Programme (SAP) needed liberalization and globalization as the principal instruments for achieving these goals. The government, therefore, adopted a phased approach to liberalise the various sectors of the economy.

The reform package included the liberalization of domestic investment, opening up of key infrastructure areas for private sector participation, opening the economy to foreign competition by reducing protective barriers such as import controls and high tariffs, deregulation of interest rates, encouraging direct foreign investment as a source of technology upgradation and non-debt finance for investment, reform of the public sector to impart greater efficiency, disinvestment of public sector undertakings (PSUs), and reform of the tax system to create a broader base of taxation by moderating tax rates.

The deregulation of industry, liberalization of foreign exchange markets and convertibility of currency require an efficient financial system. Hence the steps to improve the financial system were an integral part of the economic reforms initiated in 1991. the improved financial system is expected to increase the efficiency of resource mobilization and allocation in the real economy, which, in turn, would induce a higher rate of economic growth. Moreover, the soundness of the financial system is one of the fundamentals for judging the health of an economy and these measures will impart it health as well as strength.

In August 1991, the government of India appointed a high level committee under the chairmanship of M. Narasimhan, former governor of the Reserve Bank of India, to look into all aspects of the financial system and make comprehensive recommendations to reform it. The committee submitted its report in November 1991, recommending reforms in both the banking sector and in the financial markets. These recommendations were gradually implemented in the beginning of 1992.

INDIAN FINANCIAL SYSTEM IN THE PRE-REFORMS PERIOD

Financial systems in developing countries, some two decades ago, were viewed primarily as tools in the hands of the government to be used in the development process. Financial institutions, on the one hand, were tapped for funds to finance government and public expenditure and, on the other hand, used to direct credit to the priority sector. Such a view of the functions of the financial system has changed. In many developing economies, the emphasis has now shifted from the government and public sector to private sector due to the government's failure to attain social objectives. The private sector, in order to survive and grow, has to rely on a developed financial system. Moreover, in this era of globalization and intense competition, a continuous flow of funds is needed, from within the country and from abroad. To attract this flow of funds, a developed domestic financial system is a prerequisite.

The role of the financial system in the development process has changed not only in the developing economics, but worldwide as well. The emphasis in the approach to the financial system in the growth process has moved from channelising of resources to efficient credit allocation, which is largely determined by market forces. Since the South-east Asian financial crises, financial stability occupies as important a place in the system as does efficiency of allocation.

After independence, India adopted a state-dominated development strategy wherein all allocation decisions were made by the government and its agencies. Accelerated capital accumulation by increasing domestic savings was considered to be the key to development. An increase in domestic savings was achieved by levying high taxes, suppressing consumption, and appropriating profits through ownership of commercial enterprises. The role of the financial system was limited in this state-dominated environment. Banks were the dominant financial system had a limited role in capital accumulation, since it could not provide incentives for higher savings as interest rates were not only controlled but also repressed. Moreover, the government pre-empted household saving through high levels of statutory and cash reserve requirements. Banks and financial institutions merely acted as deposit agencies.

The resource mobilization in the primary capital market was also subject to several controls which prevented the process of price discovery. The allocation decisions were made by the government, limiting the allocative efficiency of the financial system. Banks and financial institutions directed credit to priority sectors at subsidized rates decided by the government. In order to offset the subsidized rates, banks charges higher interest rates from other borrowers and paid lower rates to depositors. These interest rate controls and high regulations inhibited proper pricing of resources and limited the allocative efficiency. Thus, the Indian financial system till the early 1990s was a closed, restricted, highly regulated, and segmented system.

In the 1990s, there was a paradigm shift in development from a state-dominated to a market-determined strategy. This shift was a result of the government's failure in achieving a higher growth rate. On the one hand, the government could not generate resources for investment or public services; on the other, there was an erosion in public savings. Thus, a a failure of the government's restrictive and regulating policies and a need to adopt a market-determined strategy of development were the causes for undertaking reforms in the financial system. Reforms aimed at improving operational and allocative

efficiency of the financial system.

OBJECTIVES OF FINANCIAL SYSTEM REFORMS

Reforms in the financial system aimed at increasing competitive efficiency in the operation of the system, making it healthy and profitable and imparting to it an operational flexibility and autonomy for working efficiently. These would result in giving the saver a wide choice with regard to instruments and institutions and enhance his confidence in the system. This would greatly augment the accumulation of capital funds.

The basic priority in the early reforms period was to remove structural rigidities and inefficiencies in the financial system. The financial system, in the 1980s and early 1990s was characerise by controls over the pricing of financial assets, restrictions on flows or transactions, barriers to entry, low liquidity, and high costs. These characteristics hindered the development of the financial system into an efficient conduit for channelising and allocating resources. Hence, the reforms primarily aimed at structural transformation in the financial system to improve efficiency, stability, and integration of various components of the financial system. Some of the structural changes initiated are free pricing of financial assets, relaxation of quantitative restrictions, removal of barriers to entry, new methods and instruments of trading, and greater participation and improvement in clearing, settlement, and disclosure practices.

The structural transformation process is now almost complete. In the second phase, the reforms aim at attaining a balance between the goals of financial stability and integrated and efficient markets.

FINANCIAL EFFICIENCY, STABILITY, AND INTEGRATION

Improving the efficiency of the financial system is one of the basic objectives of regulators. An efficient financial system is one which allocates savings to the most productive uses. Besides allocating financial resources, it also ensures the following.

- Information arbitrage efficiency, i.e., whether market prices reflect all the available information.
- Fundamental valuation efficiency, i.e., whether company valuations are reflected in stock prices.
- Full insurance efficiency, i.e., whether economic agents can insure against all future contingencies.

Financial markets and financial institutions are the two important components of a financial system. A financial system's efficiency is reflected in the efficiency of both financial markets and financial institutions. Several steps have been undertaken to improve the efficiency of financial institutions and markets. Liberalization of interest rates, reduction in reserve requirements, increasing competition by allowing new private sector players, advances in technology, introduction of prudential norms such as income recognition, provisioning, and capital adequacy, and laying down of standards for corporate governance are some of the steps undertaken to improve the efficiency of the banking sector. In case of financial markets, repealing of the Capital Issues (Control) Act, 1947, free pricing, retionalisation of the process of price discovery in the form of book building and auctions, enhancing transparency through strict disclosure norms, improved tranding and settlement practices, enlarging the number of participants, introduction of a transparent takeover code, encouraging the growth of firms both at home and abroad, rationalized tax structures, encouraging good market practices, introduction of real time gross settlement (RTGS) and other electronic payment mechanisms are some of the measures which have helped in improving information efficiency and bringing down transaction costs.

Financial stability has been an important goal for the regulators after the South-east Asian currency and financial crisis. Financial stability is crucial in this era of globalization, which has increased mobility of international capital flows, and the risk of contagion of financial crisis among countries. Liberalization and deregulation also pose several risks to financial stability. Financial instability arises due to weak fundamentals and institutional failures, resulting in panic or information asymmetry. As stated in the RBI's Report on Currency and Finance (2004), financial stability in India would mean (a) ensuring uninterrupted financial transactions, (b) maintenance of a level of confidence in the financial system amongst all the participants, and (c) absence of excess volatility that adversely affects real economic activity. In order so ensure financial stability, the government has adopted a three-fold strategy.

1. Strengthening linkages across institutions and markets.
2. Promoting soundness of financial institutions through prudential regulation and supervision.
3. Ensuring the overall macro-economic balance.

THE RESERVE BANK HAS FOLLOWED A THREE-PRONGED STRATEGY TO MAINTAIN FINANCIAL STABILITY.

1.Maintaining the overall macro-economic balance, especially through the twin objectives of price stability and growth.
2.Enhancing the macro-prudential functioning of institutions and markets.
3.Strengthening micro-prudential institutional soundness through regulation and supervision.

The Reserve Bank maintains orderly conditions in various financial markets by adopting flexible operating procedures and instruments of monetary policy. The LAF operations coupled with open market operations help in absorbing liquidity to maintain financial stability. The Reserve Bank instituted the Market Stabilization Scheme (MSS) to absorb persistent capital flows. The stock markets and market participants could withstand the volatility that occurred on May 17, 2004 when the results of the general elections were declared.

The operation of a financial system is influenced by overall economic activity and macro-economic Changes. Hence, assessment of financial soundness and stability requires the development of macro prudential indicators. These indicators are quantitative variables, which comprise both micro-prudential indicators of the health of individual financial institutions, and macro – economic variables related with financial system soundness. Macro – prudential indicators can help a country to assess its banking system's vulnerability to crisis;

They can be extended even to financial markets. The Reserve Bank monitors macro prudential indicators and makes them publicity available through its reports to enhance the discoursers of key financial information to markets. Macro-economics indicator includes sets of indicators on the real economy, trends in balance-of-payment level and volatility of inflation, interest and exchange rates, growth of credit, correlation among financial markets, trades spillover, and contagion from investor behavior. Micro-prudential indicators includes indicator on capital adequacy, assets quality of lending and borrowing entitles management soundness, liquidity, sensitivity to market risk, and some market based indicators such as market prices, ratings of financial institutions. To ensure financial stability, the government replaced ad hoc t-bills with the system of ways and means advance to rises funds.

Integrated markets are unified markets wherein participant in one market have unrestricted access to other markets. This brings about an overall equality of returns over markets. The money market, the capital market, and the foreign exchange markets remained segments till the early 1990s due to high level of regulation and restrictions. An integration of markets is necessary for effective transmission and implementation of policies and for facilitating better functioning of markets. To enable integration, interest rates were freed, foreign capital flows and foreign participants were allowed entry, domestic companies were permitted to raise funds from outside, and participants were allowed to operate in different markets simultaneously. Besides, introduction of new product such as repose and derivatives, and improvements in technology and payment and settlement infrastructure have facilitated integration of financial markets in India. The integration of the domestic financial markets within themselves and with the foreign exchange market is reflected in trends in turnover and prices of securities in financial markets. Besides this, an analysis of the transmission of volatility in one market to other markets also helps in knowing the extent of integration of financial Markets. The linkage between the call money market and foreign exchange market is found during times of volatility in foreign exchange market as commercial banks have a dominant presence in bot the markets. An increase in foreign investment flows increases cross – border financial integration. As a result, the sensitivity of the Indian technology stocks to movements in the NASDAQ composite index was high in 1999-2000. The movements in the Indian stock indices are correlated with the movements n the global stock indices. The domestic integration of various segments of financial markets has been facilitated by the expansion of the online operations of two major stock exchanges the BSE and the NSE. The regional stock exchanges have been integrated with the Interconnected Stock Exchange of India Ltd (ISE) In addition, regional stock exchanges have become members of both the BSE and the NSE.

CONCLUSION

The Indian financial system is fairly integrated, stable, and efficient.. There are weaknesses in the system which need to be addressed. These include a high level of non performing assets in some banks and financial institutions, disciplinary issues with regard to non banking financial companies, government's high domestic debt and borrowings, volatility in financial markets, absence of a yield curve, and co operative bank scams.

The reforms in the financial have been more capital market centric in nature. The crisis in financial institution such as UTI, IFCI, and IDBI unfolded the failure of prudential regulations and the

government had to bail them out by refinancing them. This eroded investor confidence in public sector institutions, leading to a deceleration in the rate of domestic saving. Foreign capital flows and foreign exchange reserves have increased but the actual absorption of foreign capital is quite low. The fiscal deficit has expanded, leading to a deteriorating fiscal scene. The spreading of the sub – prime mortgage crisis, high inflation and depreciating rupee has put a pressure on the GDP growth rate.

The growth rate of GDP has increased since 2003-2004 but it needs to be sustained. India has still a long way to go. We can achieve a growth rate of 8 per cent for which we need reforms in key areas such as agriculture, power and labour. Greater consolidation and competition among banks and other financial intermediaries such as mutual fund and insurance companies is needed to lower the costs of intermediation and expand.

The economic reform process of liberalistion and globalization was introduced in the 1990 to improve performance of all sectors and making India globally competitive. Structural reforms, encompassing all sectors of the economy, involved reorientation towards a market – based economy for fostering sustainable growth and stability.

The reforms have transformed India from a closed and trailing economy to liberalized and economy. The financial sector reforms have aided growth, avoided crisis, enhance efficiency and imparted resilience to the system. This could be achieved, as the reform process was gradually implemented, coordinated with other economic policies and sequenced with international trends. Reforms in the financial sector created a deregulated environment and enabled free play of market forces.

The growth rate of the economy had collapsed to only 0.8 per cent 1991. However, with the advent of continuous economic reforms, the economy has recorded an average growth rate of around 6 per cent in the last decade. Indicial has been able to break free from the dismal Hindu rate of growth of 3.5 percent and is now on a 8 per cent and is now on a 8 per cent growth trajectory. The Indian economy grew at 9.6 per cent in 2006-07, making it one of the world's fastest growing economies.

The abolishment of license raj and bottlenecks of control have given a lot of freedom to the Indian industry. The lowering of taxes, customs, and excise duties have triggered investments in manufacturing, improved margins, and given a greater choice to the consumer. A host of foreign players have entered the manufacturing sector leading to a significant increase in competition.

The economic fundamentals are improving. Exports are increasing and India's is a destination for software services and business process outsourcing. New areas such as generic pharmaceuticals auto and ancillary and engineering product are contributing towards export growth. The Indian industry underwent a restructuring phase and is now moving into the investment cycle for expansion and modernization. Indian industries have built world class size manufacturing capacities, acquired companies, improved quality and efficiency, and become globally competitive.

The core objectives of the financial sector reforms are strengthening of the financial sector and improving the functioning of the financial markets. Indian stock markets are one of the most exciting and vibrant markets of the world. They have the highest number of listed companies with a 300 million strong investor community. The average trading volume in these markets is now around a trillion dollars a day. The liquidity in the stock markets has increased. The return on equity in India is one of the highest in the world. Shares are trading at a price earrings multiple of 15. A large number of foreign institutional investors (?FIIs) have setup separate India sections for trading in these markets. In the US alone, there are more than 5,000 India dedicated mutual fund schemes. The stock market index reached a peak of 21000 in January 2008. Indian markets have come a long way since the 1992 scam. A lot of infrastructural issues such as on line trading, demat, rolling settlements, and disclosures have been taken care of. Moreover the time period between issue closure and listing has been reduced to six days as against the earlier 15 days.

India's financial sector is integrating with that of the rest of the world. The interest rates have been freed, the statutory provisions have been reduced and prudential norms have been strengthened for players in the financial sector. Reforms have altered the organization structure, Ownership pattern, and domain of operations of financial institutions and infused greater competition.

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