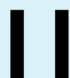

II THE THEME

2.1 The world of finance has changed markedly over the last 30 years or so. The change has been brought about by a number of events and circumstances. The growing dissatisfaction with the working of the fixed exchange rate system during the 1960s led many countries, especially of the industrialised world to adopt floating exchange rate system by the early 1970s. There was also a growing realisation that for achieving sustained growth with stability, it would be necessary to have freer trade, liberalised external capital movements, and a relatively flexible use of domestic monetary policy. With trade being subject to multilateral negotiations, industrialised countries and some of the emerging market economies took steps to liberalise capital movements across countries since about the middle of the 1970s. Simultaneously, efforts were made to remove distortions in the domestic financial sector through elimination or containment of reserve requirements and interest rate regulations. These initiatives coincided with the rapid technological improvements in electronic payment and communication systems. The interactions among these factors helped the process of internationalisation of financial markets. Under the impact of economic liberalisation, the industrialised countries as a group improved their relative economic position in the world economy, and posted high growth rates in the 1980s and thereafter. This experience has confirmed the analytical expectations about the release of impulses of growth with financial liberalization, best articulated by McKinnon (1973) and Shaw (1973) in the case of developing countries[1]. The emergence of financial innovations consequent upon financial development and global integration has cast doubts about the effectiveness of having simple rules of monetary policy, such as, monetary targeting. As a result, domestic monetary policy making has had to be adequately flexible to attain the specified objective(s). This development implies that the interface between the financial market dynamics and monetary and exchange management has to be continuous and mutually reinforcing. It is by now recognised that the behavioural relations that evolve out of this interface would provide critical insights about the state of the development, diversification, efficiency and integration of financial markets as also the elements that constitute the transmission channels of monetary policy.

2.2 Developing countries on their part have been adopting since the early 1980s market-oriented strategies of financial development partly supported by the international financial institutions and partly to avail of the large pool of resources available in international financial markets. They either dismantled or sharply contained "financial repression" and undertook financial reforms with a view to enhancing allocative efficiency and competitiveness. Financial development, as a major objective of financial reforms, required the deepening and widening of the existing financial markets as well as the introduction of new products and instruments to cater to the needs of savers and investors. With financial development, secondary markets would become prominent and ensure that financial sector integration is rendered possible.

2.3 Financial development would, however, depend on market based regulatory framework and incentives (disincentives) that promote market discipline. Where market discipline is not well understood or not complied with, there would arise possibilities of inefficiencies and/or volatilities in asset prices to emerge. Financial stability, therefore, has to be pursued for financial development to be sustained and strengthened so as to ultimately result in improvement in output growth.

2.4 The process of deregulation and globalisation of financial markets gained momentum in the 1990s, and expanded the choices for investors, and helped to improve the prospects of reducing the costs of financial

1. McKinnon, R.I., (1973), *Money and Capital in Economic Development*, Brookings Institution, Washington D.C.
Shaw, G.S., (1973), *Financial Deepening in Economic Development*, New York, Oxford University Press.

transactions and improving operational and allocative efficiency of the financial system. A number of developing countries especially in Asia, that moved early on to the path of economic liberalisation had experienced large capital inflows through the 1980s and the first half of the 1990s. Large capital inflows, however, carried the risk of financial sector vulnerability, where the use of such flows is not buttressed by application of appropriate mix of macroeconomic and structural policy measures. The recent currency and financial crises in Mexico and Thailand, followed by Korea and Indonesia, provide many insights about the problems that would arise when exchange rates are inflexible, and banking and financial systems are weak.

2.5 The experience of the crisis-affected countries highlights the need for setting in place regulatory and supervisory framework to ensure the safety and stability of financial systems. Their experience also underscored the premise that financial development is only a necessary condition of sustainable growth, and by no means sufficient. In fact, with the incidence of the costs of financial crises falling on the sovereign governments, financial stability has come to occupy a centre-stage in public policy making along with the requirement of ensuring that the efficiency of financial sector is high. In this context, the discussions on financial development have focussed on a wide range of issues - the overall redrawing of boundaries between the State ownership of financial entities and private sector ones, corporate governance in banks and other segments of the financial systems, transparency of policies and practices of the monetary and financial agencies and accountability, prudential requirements of market participants together with comprehensive and efficient oversight of the financial system, maintenance of best practices in accounting and auditing, as also collection, processing and dissemination of symmetric and detailed information to meet the market needs. The commonality among these concerns has given rise to a wide recognition and acceptance of having a set of international standards and best practices that every 'systemically important' country should strive to foster and implement.

2.6 In view of the criticality of the working of this sector for India, this Report would focus on "**Financial Sector and Market Integration**" as its main theme. The Report would analytically view the developments in the financial markets and discuss the issues that have arisen with particular reference to the period since the early 1990s. The choice of this period is dictated by the fact that liberalisation of financial markets in a true sense began in the late 1980s and was dovetailed into a comprehensive programme of reforms initiated in the early 1990s. As the financial sector reforms are still being pursued along with reforms of the real sector (agriculture and industry in the main) and trade, and to an extent the labour market, it would be difficult at this stage to make definitive assessment of the performance of the sector and of the liberalisation experience. However, the analysis will help provide a detailed account of processes through which the markets have evolved and are getting increasingly integrated. The sequencing of policy measures following the analytical underpinning and live experiences of countries elsewhere would form an important part of the account being related in this Report.

2.7 The Report analyses the issues relating to financial development, financial market structure, financial integration and efficiency as also financial stability with reference to India. Although the issues are of recent origin, the use of the data pertains to different time periods, depending on the needs of analysis.

2.8 Among the various economic reform measures undertaken in recent years, those relating to the financial sector were many and sharply focused. Chapter III (**Financial Development and Economic Growth in India**) provides a broad spectrum of indicators often used to measure financial development. Various indicators show that the Indian financial system has become fairly deep over time. Among the two broad sources of finance, *viz.,* intermediaries-based and market-based, the relative importance of the latter has grown in the 1990s, even though the former continues to be the main source of financing. The empirical exercise presented in Chapter III suggests that financial development and economic growth reinforced each other.

2.9 The organisational structure of the financial markets has important implications from the point of view of integration, efficiency and stability. A competitive market structure and transparent trading practices help in improving allocative efficiency of resources. With the initiation of financial sector reforms, a significant transformation has occurred in the structure of various segments of the financial markets.

Chapter IV (**Financial Market Structure**) analyses the structure of various financial markets (the credit market, the money market, the foreign exchange market, the debt market, the capital market, the insurance market and the derivatives market) as it evolved during the 1990s.

2.10 In a market oriented economy, segmented markets could not only obscure the transmission of public policies but also give rise to sub-optimal allocation of resources. Financial markets in India which remained segmented for long are getting increasingly integrated both domestically and internationally following initiation of financial sector reforms in the 1990s. Chapter V (**Financial Market Integration**) analyses, in detail, various aspects of the integration of financial markets in India. Integration of domestic financial markets is analysed in terms of the linkages across the term structure of interest rates and between interest rates and other asset prices, particularly stock prices. Cross-border integration is studied through various indicators of openness to trade and finance as also the standard international parity conditions.

2.11 As fragilities in the financial system could cause serious damage to the real economy, the importance of policy actions to safeguard financial stability can hardly be over-emphasised. While a modicum of volatility is an integral part of development and integration of the financial markets, excessive volatility could, however, turn out to be destabilising, thereby making the economy vulnerable to a variety of risks. In order to ensure stability of the Indian financial sector, a wide array of measures have been adopted. Chapter VI (**Reinforcing Financial Stability**) analyses the macro and micro prudential indicators of the financial system, issues of transparency, policy credibility and policy responses to achieve the requisite levels of transparency. The fiscal policy issues having a bearing on financial stability and the criticality of co-ordination among fiscal, monetary and exchange rate policies in ensuring financial and macroeconomic stability have also been examined.

2.12 Finance plays an important role in the process of economic development. For performing this role effectively, it is necessary that both financial institutions and financial markets are efficient. Various reform measures initiated in the 1990s are, *inter alia*, aimed at making the financial institutions and markets efficient. Chapter VII (**Financial Sector Efficiency**) examines, in detail, financial sector efficiency, especially of the banking sector. Efficiency of both the markets and the institutions has improved following competitive pressures resulting from deregulation of financial markets, advances in technology, blurring of distinctions among providers of financial services and increasing integration of markets.