I THEME OF THE REPORT

1.1 A well-functioning financial system is a *sine qua non* for the pursuit of economic growth with stability. The core function of a well-developed financial system is to facilitate smooth and efficient allocation of resources from savers to the ultimate users. That an efficient financial system is a key to development is not new in the economic literature. In fact, in his classic, *Lombard Street* : *A Description of the Money Market (*1873), Walter Bagehot had argued that it was England's efficient capital market that made the industrial revolution possible. Bagehot was the first to define the two primary roles of financial markets. One, they facilitate the accumulation of capital. Two, they manage risk inherent in particular investment projects and industries.

1.2 The most important and thorough recognition of the role of financial development in economic development came in 1912 when Joseph Schumpeter contended that financial development promotes economic growth by improving productivity. However, this view had fallen out of mainstream thinking for quite a long time as several prominent economists subsequently acknowledged that the financial systems were an essential feature of an advanced economy, but argued that they did not themselves contribute to growth. For instance, Joan Robinson (1952) argued that financial systems emerge in a passive way to respond to the needs of the real economy. In fact, early empirical work appeared to suggest that although economic growth and financial development occurred in tandem, there was no evidence of a causal relationship. This view was generally accepted over the 1950s through the early 1970s. Academics and policy makers during this period believed that finance emerges in an economy only after a certain stage of development. To the extent finance appeared in the early development literature, it was only to advocate that the financial system could be managed to achieve certain societal goals. In fact, many developing countries were encouraged to favour the flow of credit to certain preferred sectors through credit rationing or interest rate ceilings. However, the observed failure of these strategies - dubbed as 'financial repression' by McKinnon-Shaw (1973) - led to the realisation of the central role played by the financial system.

1.3 There has also been a better understanding of the role of financial systems in advanced economies through endogenous growth theory. The key to growth in this model is continuous productivity advances that take place through technological advancement. This makes productivity the main engine of growth. One of the crucial structural factors that affects productivity is the financial system (King and Levine, 1993). This view was in line with the view earlier suggested by Schumpeter. According to Levine (1997), financial services affect economic growth through five main channels, *viz.*, saving mobilisation, resource allocation, risk management, management monitoring and trade facilitation. Each of the five main channels contributes to both capital accumulation and the process of technological innovation. These, in turn, feed directly to economic growth by the Solow growth model.

1.4 Financial reforms and liberalisation that have taken place in emerging economies in the 1980s and the 1990s have been largely inspired by the Mckinnon-Shaw thesis (1973). However, financial crises of the last decade vividly established that a weak financial system not only makes a country, open to international capital flows, more vulnerable to crises, but also exacerbates the costs of any financial crisis that does occur. Over the past decade, many emerging market economies have, therefore, made significant efforts to strengthen their domestic financial systems, including financial markets – the money market, the government securities market, the foreign exchange market and the equity market. Local bond markets are now the dominant source of funding for the Governments in several countries. There has been some improvement in the domestic corporate bond market as well in some countries, although the progress has been slow in this segment of the market.

1.5 What are then the key objectives of financial market development? From the viewpoint of an emerging economy like India, the basic aim of financial market development must be to aid economic growth and development. The primary role of financial markets, broadly interpreted, is to intermediate resources from savers to investors, and allocate them in an efficient manner among competing uses in the economy, thereby contributing to growth, both through increased investment and through enhanced efficiency in resource use (Mohan, 2007).

1.6 Financial markets in India have existed for a long time. However, they remained relatively underdeveloped for a variety of reasons. India introduced financial sector reforms as a part of structural reforms in the early 1990s. Since then, momentous changes have taken place in the Indian financial sector, including financial markets. Reforms in the financial markets encompassed all segments - the money market, the credit market, the government securities market, the foreign exchange market, the equity market and the private corporate debt market. The development of financial markets in India has been pursued to bring about a transformation in the structure, efficiency and stability of markets as also to facilitate integration of markets. The emphasis has been on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. During the post-reform period, the structure of financial markets has witnessed a remarkable change in terms of financial instruments traded in various segments of the financial market and market participants. Development of these markets has been done in a calibrated, sequenced and careful manner in step with those in other markets in the real economy. The sequencing has also been informed by the need to develop market infrastructure, technology and capabilities of market participants and financial institutions in a consistent manner. In a low income economy like India, the cost of downside risk is very high, so the objective of maintaining financial stability has to be constantly kept in view while developing financial markets (Mohan, 2007).

1.7 Financial sector reforms have had a profound effect in terms of aiding growth, while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system (Reddy, 2000). Although various segments of the financial market, in general, have certainly become deeper and more liquid, there is still some way to go before all the segments of the financial market are fully developed. Whereas it has always been the endeavour of the authorities to develop financial markets, the need for developed financial markets has never been so strongly felt as at this point of time. The need for sustaining higher economic growth, improving the transmission mechanism of monetary policy, developing a diversified financial system, maximising the gains from financial integration and minimising its costs, and preparing for smooth capital account convertibility, all point to the need for continuing sustained and perhaps accelerated efforts at developing financial markets in India.

MOBILISING RESOURCES FOR SUSTAINING HIGHER GROWTH

1.8 The primary role of the financial system in any economy is to mobilise resources for productive investment and thereby enhance productive capacity of the economy. A developed financial system broadens access to funds; conversely, in an underdeveloped financial system, access to funds is limited and people are constrained by the availability of their own funds and have to resort to high cost informal sources such as money lenders (Mohan, 2006c). Domestic financial markets are a critical pillar of a market based economy. The vital role of financial markets emanates from the fact that the needs of savers and investors, in general, are not homogenous in nature. Financial markets also facilitate trading of instruments and thus allow speedy exit. Saving essentially involves future consumption, the preference for which would vary depending on the requirements of liquidity, time (or maturity), safety and risk, and expected returns. Similarly, investment needs are different across enterprises. Financial markets thus play an important role in providing an array of instruments of various maturities and other features to satisfy various needs of savers and investors. In the absence of such instruments, capital mobilisation will be less than adequate. A shallow financial system, characterised by a limited number of instruments, cannot mobilise potential savings and meet investment requirements for several productive sectors with the attendant implications for the economic performance.

1.9 Realising the importance of financial sector development for high and steady growth and development, policy makers in emerging market economies (EMEs) and developing countries have been making efforts to provide appropriate regulatory environments for financial markets that (i) encourage competitive forces; (ii) facilitate the use of a variety of instruments; (iii) promote the growth of different kinds of institutions offering a wide range of financial instruments and services to potential savers and investors; (iv) protect the interests of savers by reducing their risks; and (v) promote the development of instruments that help in risk management. For regulating financial markets, regulators are guided by various considerations in the larger interest of society. Broadly, the objective of regulation is to protect depositors' and investors' interests (safety and conduct of business), promote financial inclusion, ensure monetary and financial stability and achieve sustained economic progress.

1.10 The Indian economy grew by 9 per cent during 2005-06 and it is estimated by the Central Statistical Organisation that it would grow by 9.2 per cent in 2006-07. The average annual growth rate in the last four years has been over 8 per cent. The gross domestic investment rate increased significantly from 23.0 per cent of GDP in 2001-02 to 33.8 per cent in 2005-06. The gross domestic saving rate also improved from 23.6 per cent to 32.4 per cent over the same period, underpinned by a significant turnaround in public sector saving and increase in private corporate sector saving. There has been optimism about the growing potential of economic growth in India. The Approach Paper to the Eleventh Five Year Plan (2007-08 to 2011-12) aims at putting the economy on a sustainable growth trajectory with a growth rate of approximately 10 per cent in the terminal year, which would yield an average growth rate of about 9 per cent in the Plan period. However, a set of issues relating to investments has been identified by the Planning Commission. An average growth of 9 per cent during the 11th Plan period requires an increase in domestic investment rate from 27.8 per cent in the 10th Plan to 35.1 per cent in the 11th Plan. While half of this increase in investment is expected to come from private investment in farms, small and medium enterprises and in the corporate sector, the rest is estimated to emanate from public investment with a focus on the infrastructure sector.

1.11 In order to achieve the desired savings and investment rates, there would be need to raise large resources domestically. India has a reasonably high and growing savings rate. However, for meeting the financing requirements of a growing economy what is important is mobilisation of financial savings. In this context, it may be noted that physical savings have been growing at a rate higher than the financial savings in recent years. Although this trend was reversed in 2005-06, physical savings still continue to be large. In order to facilitate substitution of physical savings in favour of financial savings, there would be need for innovative and attractive financial instruments. Appropriate instruments should also be available for the generation of longer term savings that are needed for financing infrastructure. Financial markets, therefore, would have a crucial role to play in mobilising resources of the required nature.

FINANCIAL MARKETS AND MONETARY POLICY

1.12 From the point of view of the central bank, developed financial markets are critical for effective transmission of monetary policy impulses to the rest of the economy. Monetary transmission cannot take place without efficient price discovery, particularly with respect to interest rates and exchange rates (Mohan, 2007). The transmission process for policy actions by central banks involves two stages. In the first stage, policy actions are transmitted to financial markets. The second stage of the transmission mechanism involves the propagation of monetary policy impulses from the financial system to the real economy and aggregate prices. A successful implementation of policy requires a reasonably accurate assessment of how rapidly the effects of policy actions are transmitted through the financial system, *via* financial prices and quantities, to the real economy, affecting aggregate spending decisions of households and firms, and from there to aggregate demand and inflation.

1.13 The first stage of the transmission mechanism depends on how changes in the market operations of central banks get transmitted through the money market to other markets, *i.e.,* the bond market and the bank loan market, which directly affect spending decisions of individuals and firms. This involves the term structure, through which short-term money market rates affect longer-term bond rates, and the marginal cost of loan funding, through which bank loan rates are affected. Since the first stage involves the propagation of changes in policy instruments through the financial system, the state of financial market development, the efficiency of institutions or intermediaries and the institutional and structural characteristics of the financial system are critical for the effectiveness of monetary policy.

1.14 Developed financial markets enable central banks to use market-based instruments of monetary policy to target monetary variables more effectively. Developed financial markets also enable monetary authorities to extract forward-looking information about certain macroeconomic variables, such as the expected future path of economic growth, inflation and financial conditions, which are important in formulating effective monetary policy.

1.15 Recent developments in the global economy have accentuated the challenges that monetary authorities face. An important challenge faced by monetary authorities in the conduct of monetary policy has been brought by the new environment characterised by increased financial globalisation in recent years. In particular, it renders economies vulnerable to changes in external demand, volatility in capital flows and exchange rate shocks. Monetary policy formulation thus becomes much more inter-dependent than before across economies and has to factor in developments in the

global economic situation, the international inflationary situation, interest rates, exchange rate movements and capital flows. As a result, while domestic developments continue to dominate, global factors are increasingly gaining more importance. Massive cross-border capital flows, globalisation of financial markets and advances in information technology have combined to alter significantly the choice of instruments of monetary policy, operational settings, lag structures and transmission mechanism (Mohan, 2004). The heightened uncertainty surrounding the conduct of monetary policy has obscured a proper assessment of the nature of shocks impacting the economy and the resulting risks to price stability. It has also made the interpretation of macroeconomic and financial data difficult.

1.16 With the gradual liberalisation of the Indian economy, there has been substantial inflow of foreign capital into India, much in excess of the prevailing current account deficit. Whereas the opening of the economy has brought about gains in terms of inflows of foreign investments with positive implications for output and employment, it has also posed new challenges for managing the macroeconomy amidst large and volatile capital flows. The market stabilisation scheme (MSS) was introduced to absorb inflows of the more enduring part of the liquidity overhang induced by excess capital flows. Suitable changes were also made in the liquidity adjustment facility (LAF) scheme. However, going forward, there will be a continuous need to adopt an appropriate strategy of active liquidity management and short-term interest rate smoothening for effective monetary management and financial stability. This issue becomes even more relevant under a freer regime of capital flows (Mohan, 2006b).

1.17 The Reserve Bank's approach has been to foster balanced development of various segments of the money market to improve the transmission mechanism of monetary policy. However, certain segments of the money market have yet to develop. As a debt manager to the Government, the development of a deep and liquid market for government securities is of critical importance to the Reserve Bank as it results in better price discovery and cost effective Government borrowing. The government securities market also provides an effective transmission mechanism for monetary policy, facilitates the introduction and pricing of hedging products and serves as a benchmark for pricing other debt instruments. Although the government securities market has developed considerably over the years, more needs to be done for it to become fully developed. A liquid and reliable yield curve, especially at the longer-end of the maturity needs to be developed further. The absence of a developed private corporate debt market also hampers the smooth transmission of monetary policy impulses. With the financial markets in India acquiring greater depth and maturity in recent years, the issue of greater integration of various financial market segments has also come to the forefront, particularly in the context of monetary policy transmission. The significance of developed and well-integrated financial markets from a monetary policy perspective thus can hardly be overemphasised.

DIVERSIFIED FINANCIAL SYSTEM

1.18 While the importance of finance is now widely recognised, it was less clear, until recently, as to what were the main features of a successful financial system. Financial institutions and financial markets are two generic mechanisms for transferring resources from surplus spending units to deficit spending units. While the financial systems in the US, the UK and other Anglo-Saxon countries relied more on capital markets, in Japan and Germany, banks dominated their financial systems. Both bank-based and market-based systems have their unique advantages and disadvantages. Banks are generally in a better position to collect and interpret information about investment opportunities and monitor projects. Banks are also better equipped to operate in a system where the legal framework is not adequately developed as they are able to make borrowers disclose the information needed by them and to repay. However, intermediaries tend to favour low-risk projects. On the other hand, capital markets may have an advantage in dealing with uncertainty and new ideas and make funding of riskier projects possible. In practice, both types of mechanisms co-exist and supplement each other, though one system may have predominance over the other.

1.19 Some argue that differences in the financial structure do matter. For instance, financial systems dominated by arm's-length transactions (markets with lower bank density and greater disintermediation) have been found to better accommodate resource reallocations from declining to expanding sectors than systems dominated by relationship-based transactions. As arm's-length transactions tend to be more characteristic of capital markets than of banks, this would suggest that economies with more developed capital markets may be more flexible and dynamic, and, therefore, more likely to experience higher productivity and growth, than those with bank-based financial systems (Rato, 2006). However, historical experience suggests that both the

mechanisms have worked well. If market-based systems were successful in the UK and the US, bank-based systems were successful in Germany and Japan. After the East Asian crisis, however, it has been widely recognised that there should be a balanced financial system wherein both financial institutions and financial markets play important roles.

1.20 Historically, financial systems in emerging market and developing economies have been dominated by their banking systems. Excessive reliance on the banking system, however, makes the financial system vulnerable to shocks and exacerbates the crises, as was observed during the East Asian crisis. Developed capital markets also enable countries to reduce their reliance on foreign borrowing. This is particularly important for emerging market countries. Since external debt has been a major source of vulnerability in EMEs, capital market development could potentially exercise a stabilising influence (Rato, 2006). Similarly, complementary or supporting infrastructure such as the repo market, margin trading and derivatives, if developed within an appropriate framework in EMEs, can be important means of reducing the transaction cost further. It also allows market participants to manage and transfer risks to those who are able and willing to bear them, which helps in developing a robust financial system.

1.21 Historically, the financial system in India has also been dominated by financial intermediaries, in general, and banking institutions, in particular. This pattern has remained more or less unaltered over the years. Households invest only a small portion of their savings in the securities market directly or indirectly through mutual funds. The need, therefore, is felt to develop a diversified financial system over a period of time in which both financial institutions and financial markets play important roles.

1.22 Developed financial markets are required not only to enable corporates to raise resources from the market, but also to enable banks to raise resources to sustain their growth. Banks need to raise capital from the market on an ongoing basis in order to sustain their operations. Their requirements of capital are also expected to increase on implementation of Basel II. Thus, banks' inability to raise resources from the capital market could stunt their growth with attendant implications for economic growth. In India, pension and provident funds hold a large corpus of funds. These funds, however, generate low returns as they have limited avenues to deploy their funds in highly rated corporate bonds. Developed private corporate debt market may enable these pension and provident funds to deploy their funds in corporate bonds and generate higher returns.

FINANCIAL INTEGRATION AND FINANCIAL MARKETS

1.23 The need for developed financial markets also arises in the context of increasing integration of domestic financial markets with international financial markets. The concept of globalisation today is no longer restricted to its traditional sense, *i.e.*, variety of cross-border transactions in goods and services, but also extends to international capital flows, driven by rapid and widespread diffusion of technology. In fact, most of the literature in recent years on globalisation has centred around financial integration due to the emergence of worldwide financial markets and the possibility of better access to external financing for a variety of domestic entities. Integration of the domestic economy with the global economy can also provide the benefits of diversification to the residents. During the 1980s, capital account liberalisation came to be seen as an essential, and even inevitable step on the path to economic development, analogous to the earlier reductions in barriers to international trade in goods and services. However, capital account liberalisation also exposes the domestic economy to certain risks. Large capital flows cause volatility, *i.e.,* tendency of financial markets to go through boom and bust cycles in which capital flows grow and then contract. Another risk is contagion, that is inability of the market to distinguish between one type of borrower and another. These risks, if not managed well, could have serious implications as was observed in the case of East Asian crisis in the mid-1990s. Inadequate or mismanaged domestic financial sector liberalisation has been a major contributor to crises that may be associated with financial integration (Mishkin, 2006). Thus, with greater financial integration, a developed, vibrant, effective and stable financial system assumes considerable significance.

1.24 Global developments, particularly those in international financial markets, have the most direct and serious impact on the financing conditions in emerging markets. Volatility in financial markets could adversely affect the EMEs in many ways, and also in a complex and interrelated fashion. For convenience of analysis, the impact may be classified broadly into: (i) the impact on the financing conditions in which EMEs operate; (ii) impairment of the balance sheets of the banking sector; and (iii) hampering of the growth prospects in the real sector (Reddy, 2005).

1.25 India has been gradually and cautiously liberalising its capital account since the early 1990s. However, in several areas capital account is still managed by the Reserve Bank. Given the large investment needs of the country, domestic savings may need to be supplemented by foreign capital, although the absorption of foreign capital is limited on a macroeconomic basis by the magnitude of a sustainable current account deficit.

1.26 With the greater globalisation of trade and relatively free movement of financial assets, risk management through derivative products has also assumed significance in India. With the Indian corporates getting increasingly integrated with overseas markets and accessing international capital markets, there is need to develop a broad-based, active and liquid foreign exchange derivatives market which provides them with a spectrum of hedging products for effectively managing their foreign exchange exposures. Derivative markets reallocate risk among financial market participants and reduce information asymmetry among investors. Derivative markets also facilitate efficient price discovery and make unbundling of risk easier (Gambhir and Goel, 2003).

1.27 Thus, if benefits from financial integration are to be maximised, it is imperative to pursue efforts towards a greater sophistication of financial markets and develop instruments that allow appropriate pricing, sharing and transfer of risks.

1.28 The need to develop financial markets has also been underlined by the two high-powered committees, *viz.*; Committee on Fuller Capital Account Convertibility (FCAC) and the High Powered Expert Committee on Making Mumbai an International Financial Centre. The Committee on Fuller Capital Account Convertibility in its Report submitted in July 2006 indicated that in order to make a move towards fuller capital account convertibility, it needs to be ensured that different financial market segments are not only well-developed but also that they are well-integrated. Otherwise, shocks to one or more market segments would not get transmitted to other segments efficiently so that the entire financial system is able to absorb the shocks with minimal damage.

1.29 Developed and well-integrated financial markets are critical for sustaining high growth, for the effective conduct of monetary policy, for developing a diversified financial system, financial integration and ensuring financial stability. The question thus is not whether we need developed financial markets, but how we should go about in developing them fully. Financial markets today deal with complex and sophisticated products. Introduction of such products would require clear regulatory frameworks, appropriate institutions and development of human resource skills. The speed for further changes in the financial markets would thus depend on how quickly are we able to meet these requirements.

1.30 Deregulation, liberalisation, and globalisation of financial markets pose several risks to financial stability. Financial markets are often governed by herd behaviour and contagion and excessive competition among financial institutions can also lead to a race to the bottom. The East Asian crisis of the 1990s suggested that global financial markets can exacerbate domestic vulnerabilities. Notwithstanding the conventional wisdom that financial markets punish deviations from prudent policies, financial markets, at times, seem to tolerate imprudent behaviour for a remarkable stretch of time, while reacting pre-maturely at other times (Lipschitz, 2007). In recognition of these possible destabilising factors, while liberalising domestic financial markets in India, appropriate prudential safeguards have also been put in place. Excessive fluctuations and volatility in financial markets can mask the underlying value and give rise to confusing signals, thereby hindering efficient price discovery. Accordingly, policy efforts have also aimed at ensuring orderly conditions in financial markets (Mohan, 2006a). Enhancing efficiency, while at the same time avoiding instability in the system, has been the challenge for the regulators in India (Reddy, 2004). This approach to development and regulation of financial markets has imparted resilience to the financial markets.

1.31 From the point of view of the economy as a whole, while developing financial markets it is essential to keep in view how such development helps overall growth and development. The price discovery of interest rates and exchange rates, and integration of such prices across markets helps in the efficient allocation of resources in the real sectors of the economy. Financial intermediaries like banks also gain from better determination of interest rates in financial markets so that they can price their own products better. Moreover, their own risk management can also improve through the availability of different varieties of financial instruments. The access of real sector entities to finance is also assisted by the appropriate development of the financial markets and the availability of transparent information on benchmark interest rates and prevailing exchange rates. The

approach of the Reserve Bank in the development of financial markets has been guided by these considerations, while also keeping in view the availability of appropriate skills and capacities for participation in financial markets, both among financial market participants and real sector entities and individuals (Mohan, 2007). The Reserve Bank's approach has, therefore, been one of consistent development of markets while exercising caution in favour of maintaining financial stability in the system.

1.32 In the last 15 years, several reform measures have been initiated to develop the financial markets in India. As a result, various segments of the financial market are now better developed and integrated. Despite considerable progress made so far, financial markets need to develop further in line with the evolving conditions. In order to strengthen the understanding of the structure of the Indian financial markets and to identify the substantive issues that need to be addressed towards meeting this objective, the theme of this Report for 2005-06 has been selected as **"Development of Financial Markets and Role of the Central Bank"**. The Report undertakes an in-depth analysis of various segments of the financial market in India in terms of inter-temporal development, cross-country comparison, highlighting the current major issues and the policy initiatives. An attempt is also made to outline the way forward for each segment of the financial market. The thrust of the Report is to assess the impact of various policy measures and to look ahead as to what further needs to be done to develop financial markets in India. Various measures suggested in this Report set out only the broad direction in which reforms in the financial markets could move in future. Their implementation would need careful sequencing in tune with the evolving domestic and global developments. The implementation of measures suggested would also be contingent upon the development of appropriate market infrastructure and market players. Participants in financial markets are exposed to various risks. These risks, therefore, need to be managed carefully. In view of this, it would be necessary to develop market players who understand the risks and have the wherewithal to manage them. The transferring of risks to those market participants who do not understand them and do not have the capacity to manage them could have serious implications for the financial system. The pace and sequencing of measures could, therefore, be calibrated keeping in view the degree of comfort in moving forward in a credible way.

1.33 The Report, including this chapter, is organised into nine chapters. As a prelude to the substantive theme based discussion, Chapter II of the Report titled "Recent Economic Developments" presents an analytical account of macroeconomic developments in the Indian Economy during 2005-06 and 2006-07 (up to the period for which data were available). Besides, latest macroeconomic developments for 2007-08, wherever available, are also covered. The chapter covers six broad sections, *viz.*, the real sector, fiscal situation, monetary and credit situation, financial markets, financial institutions and the external sector.

1.34 The theme based Report begins with Chapter III on "Money Market". The money market is a key segment of the financial market as it provides the fulcrum of monetary operations conducted by the central bank in its pursuit of monetary policy objectives. Besides providing an equilibrating mechanism for demand and supply of short-term funds for banks and other entities, it ensures an efficient market clearing price, while enabliing the central bank to intervene for influencing both the quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy. After delineating international experience on money market operating procedures, instruments, objectives, the evolving practices in liquidity management operations as well as the structures of money markets, the chapter deals with various aspects of the money market in India. The chapter focuses on the changing role of the Reserve Bank's liquidity management operations, in line with the shifts in the operating procedures, that shaped the development of the money market. It also spells out the role of risk management and the Reserve Bank's proactive role in mitigating various risks in the money market. Emerging issues in monetary and liquidity management in India and the need for addressing these issues in future for the smooth functioning of the money market and the efficient conduct of monetary policy have also been highlighted in the chapter.

1.35 Chapter IV titled as "Credit Market" deals with various aspects of the credit market in India. After a brief outline of the theoretical underpinnings on the significance of the credit market in economic growth, the chapter sets out the structure of the credit market in India and policy measures initiated to develop it along sound lines since the early 1990s. The focus of the chapter is on trends in credit growth in India since the early 1990s with a special emphasis on rapid credit growth in recent years. Aspects relating to the credit channel of monetary policy, analytical issues relating to credit boom and monetary policy and the

relationship between bank credit and asset prices have been addressed comprehensively. The way forward for further strengthening the role of the credit market has been outlined.

1.36 Chapter V titled as “Government Securities Market” covers various aspects of the government securities market in India since the early 1990s and attempts to identify the key issues that need to be addressed to meet the emerging challenges. The chapter begins with the theoretical underpinnings and principles and policy strategy for developing a deep and liquid government securities market, both primary and secondary, based on the international experience. While outlining the developments in the government securities market in India, the chapter underscores the role played by the Reserve Bank in developing this market segment since the early 1990s. Finally, the chapter raises some issues that need to be addressed for enabling the government securities market to play a more vibrant role in the emerging scenario, especially in the context of the Fiscal Responsibility and Budget Management (FRBM) Act and move towards fuller capital account convertibility.

1.37 Chapter VI titled as “Foreign Exchange Market” attempts to analyse the role of the central bank in developing the foreign exchange market. After a brief overview of different exchange rate regimes being followed in EMEs, it traces the evolution of the foreign exchange market in India along with the shifts in exchange rate regime in the post-independence period. Regulatory and policy initiatives by the Reserve Bank and the Government of India for developing a vibrant foreign exchange market have been covered in the chapter. It also spells out the current foreign exchange market structure and market infrastructure in terms of market players, trading platform, instruments and settlement mechanisms. This is followed by an assessment of the performance of the Indian foreign exchange market in terms of market liquidity and efficiency. Empirical exercises have also been carried out relating to the behaviour of forward premia, bid-offer spreads and determinants of market turnover. It also traces the journey of the Indian foreign exchange market since the early 1990s, especially through periods of volatility and its management by the authorities. Further measures needed for deepening the foreign exchange market to meet the emerging challenges of financial integration have been outlined.

1.38 Chapter VII titled as “Equity and Corporate Debt Market” is broadly divided into two sections, *viz.*, the equity market and the corporate debt market. A discussion on theoretical underpinnings of the role of the stock market in financing economic growth is followed by an overview of the measures initiated to reform the capital market in India since the early 1990s. It then assesses the impact of various reform measures on size, liquidity, transaction cost and volatility in the stock market in India. The performance of the equity market in India has been compared with select international markets, wherever possible. A brief account of the asset prices along with the wealth effect and its impact on aggregate demand is also presented. In the section on the corporate debt market, the need for developing the private corporate bond market for promoting growth and creating multiple financing channels, especially for an emerging country like India, has been spelt out. This is followed by a description of the evolution of the debt market in India from the mid-1980s onwards, the emergence and the predominance of the private placement market, and the factors that are hampering a healthy and vibrant growth of this segment of the market. The chapter draws attention to the path forward for enhancing the role of the primary equity market and for developing the private corporate debt market in India in the light of select cross-country experiences.

1.39 Chapter VIII of the Report titled as “Financial Market Integration” begins with the conceptual framework of financial market integration. This is followed by a discussion on different dimensions and benefits and risks of financial market integration. It then outlines the various policy measures undertaken in India, which have facilitated the integration of various financial market segments. After delineating briefly the phases of domestic market integration in India, the chapter presents a detailed empirical analysis on the integration of various segments of the financial market in India, *viz.,* the government securities market, the credit market, the foreign exchange market and the capital market. Issues relating to market integration and monetary policy have also been highlighted. Various aspects of global and regional integration and India’s international financial integration have also been covered. As a way forward, the chapter suggests certain measures to further strengthen the process of financial market integration in India.

1.40 Chapter IX titled as “Overall Assessment” sets out some final reflections for further developing and integrating the various segments of the financial market in India.