BANKING, FINANCE AND DEVELOPMENT *

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It gives me great pleasure to associate myself with the First Afro-Asian Banking Summer School hosted by the Indian Institute of Bankers in this beautiful garden city of Bangalore. The Institute had earlier hosted, in September 1988, the 41st International Banking Summer School, the first ever to be held in a developing country. I am glad the Institute has now taken the initiative to bring together the banking fraternity from Asia and Africa. May I, on behalf of the Institute and on my own behalf, welcome you all most cordially to this Summer School and wish you a pleasant and useful stay in India.

You are perhaps aware of the reasons which have led to the organisation of this Summer School. First, it was not feasible for the International Banking Summer School to provide sufficient representation to the numerous countries of the Afro-Asian region. Secondly, it was felt that an Afro-Asian School would be in a position to place increased emphasis on topics which are of greater relevance and interest to bankers of the region. It is a matter of great satisfaction that this initiative has evoked a positive and enthusiastic response.

The theme for this School, namely, **"Banking, Finance and Development"** is particularly appropriate as development and growth have been the major preoccupation of the region and when both development experiences and the world of banking and finance are at their crossroads. A large number of Asian countries have registered moderate to high rates of growth, built their infrastructures and diversified their economies. This is also true of some countries in Africa though there has unfortunately been a setback to the growth momentum in Sub-Saharan Africa, particularly in the 1980s due to a difficult external environment, high debt burdens and adverse weather conditions. However, thanks to the sense of purpose and flexibility with which the Governments of that region are responding to the emergent situation and the support of the international community there is hope that these countries will resume their march to progress. Also, on the one hand, the banking and financial revolution which has spread across the globe, has given rise to some questions particularly in developing countries and, on the other, the existing development strategies of a dirigiste nature have come under closer scrutiny and are yielding place to more flexible and market-dependent strategies.

The Role of Finance in Development

The role of finance is complex and differs from country to country and from one stage of development to another. The economic well-being of a nation is determined by the real sector activities in agriculture, industry and services, and in employment, consumption and investment. The financial sector representing money and credit and the whole spectrum of banking and other institutions lubricates the engine of growth in the real sector by mobilising savings, extending credit and enabling investments to be made according to national priorities. Its role is thus essentially to mediate between savers and users of surplus funds. Savings in driblets are augmented into a national pool of investible funds. Financial institutions pool risks, rank alternative investment propositions through appropriate project appraisal criteria and raise productivity of investment. They also contribute to identifying and nurturing of new entrepreneurs.

For developed countries, which experienced the process of economic development over two centuries ago under conditions of frugality and dexterity, self-finance by economic units was the primary source of capital accumulation. For the present-day developing world, time is of the

* Inaugural address by R.N. Malhotra, Governor, Reserve Bank of India, at the first Afro-Asian Banking School 1990, organised by Indian Institute of Bankers at Bangalore on November 28, 1990.

essence. Rising aspirations place pressures on limited savings and there is a broader role for credit in investment and in entrepreneurial development. Unlike in developed countries where market forces help to evolve financial institutions and instruments, the developing economies have to make deliberate efforts to promote and nurture diverse institutions and instruments as part of the process of development. With the system of physical controls and regulations gradually losing its hold the banking industry and financial system in developing countries will have a larger role in establishing investment and production priorities.

Banks play a special role in the financial system as they provide a payments mechanism in addition to saving mobilisation and credit allocation. The credit creation capacity of the banks provides additional liquidity to the financial system. Banks are therefore well-suited to develop vast branch networks and carry their facilities to the doorsteps of the common man.

The size and quality of banking and financial services vary greatly from country to country reflecting the differing states of national economies and technological development. At one end, there are the highly developed financial markets of Japan, Singapore and Hong Kong. Several other countries in the region are modernising their banking and securities markets fast. It is, however, interesting that in the post-colonial period, there has been an amazing similarity in the evolution of banking structures and systems in a large majority of the developing countries of Asia and Africa. Broadly, the initial stages of development saw strong governmental intervention in control and often ownership of banking institutions. This was followed by the setting up of specialised financial institutions and development banks for providing long-term loans and investment capital for industry and agriculture. In the operations of banks, the system of directed credit at controlled rates of interest has been common. Likewise, the dependance of governments on the banking and the monetary systems for their own financing needs in particular and those of the public sector in general has been a near universal phenomenon. This picture still prevails in many countries and has been a subject of some debate and controversy. In particular, supporters of privatisation and advocates of less government intervention have criticised public ownership of banking institutions, directed credit, concessional rates of lending to certain sections of borrowers as well as the dependence of government and the public sector on the banking system. It is, however, necessary to view this evolution in the light of objective analysis.

First, it has to be remembered that in most developing countries of the region banking systems were not well developed and their reach and focus of activity were limited. This was still more true of their capital markets which typically follow, often with considerable lag, development of the banking sector. It would appear in retrospect that government intervention has had the effect of ensuring the rapid expansion of banking which has widened and deepened the financial infrastructure, helped mobilisation of saving and increased availability of credit. It is also not surprising that in the absence of capital markets, governments which played an active role in the economic sphere have had substantial recourse to bank funds.

Secondly, direction of credit to specified sectors have increased the flow of resources to farmers, village and small industry and weaker sections of society who might otherwise have been bypassed by the banks. Availability of credit to farmers, together with physical and extension inputs, have helped raise agricultural production. Similarly, credit for village and small industry has helped large members of new entrepreneurs to establish businesses and has stimulated employment. A degree of cross subsidisation could have also helped the small man at the expense of large borrowers.

At the same time, it would appear that if these policies go too far, or are not rightly implemented, they can adversely affect the healthy functioning and financial viability of the banking system. For instance, where fiscal imbalance is large leading to excessive borrowing from the banks, often at low rates of interest, there can be crowding out

of other borrowers. To contain the growth of liquidity, monetary authorities often raise the level of sterilisation of bank funds as open market operations are not feasible due to low coupon rates of government bonds. Again, if cross subsidisation between various categories of bank borrowers becomes excessive, several distortions arise. If the interest rate payable by large borrowers become too high and cannot be supported by the available rate of return, business activity can suffer. Often, to prevent this the deposit rates may be kept at relatively low levels. However, where a financial system is growing fast, banks could become less competitive in mobilising resources.

Inefficiencies in implementing policies regarding lending to preferred sectors can also cause problems, particularly if norms and sound procedures for lending are deemphasised of the environment for recycling of bank funds deteriorates and wilful default becomes common for want of effective and prompt recovery systems. The same difficulties may be experienced even with regard to large industrial borrowers if enforcement of bank claims is weak or non–viable units have to be supported in the absence of appropriate exit policies.

It will be seen that the issues are highly complex and have to be resolved in the light of conditions prevailing in each country. In any case, there are good grounds for subjecting all these policies to a critical scrutiny with a view to reducing rigidities and improving systems. It is of the utmost importance that the banking system which garners deposits from the public and plays a crucial role in the economy, maintains its financial strength and enjoys a high degree of confidence.

Indeed, banking in Asia and Africa has entered a phase of financial reform and deregulation. In the 1980s, many countries have attempted some measures of reform in periods of economic stress as part of their stabilisation and structural adjustment programmes. Such reforms include: reduction in governmental intervention, even privatisation of ownership, greater role for traditional non-banking financial intermediaries, more liberal approach for branches of foreign banks, and diversification of banking activities into para-banking areas. These institutional changes are accompanied by significant policy reforms and introduction of flexibility in regard to directed credit, deposit and lending rates, and money market operations. The new stance also favours despecialisation to an extent, promotion of competition and a flexible approach to financial development. In addition to institution and instrument development, several countries have applied communications and computer technologies to modernise their systems and enhance their competitiveness and international orientation. Following liberalisation, competitiveness of the banking system has increased though the degree of response varied from country to country.

However, wholesale financial deregulation and liberalisation can cause serious problems if the overall economic setting in a country is not propitious. For instance, such liberalisation in the Southern Cone countries of South America was not an unmixed blessing in face of high inflation and macro-economic imbalances. Some countries in the Afro-Asian region also suffered similar experiences.

Except for such few instances, the authorities undertaking financial reforms in the African and Asian countries have generally observed the required caution and the necessary ground rules. The lessons of financial liberalisation and the ground rules, which I have highlighted elsewhere, bear repetition:

(i) Financial reforms against an unstable macro-economic background can make the instability worse; therefore, reforms should be attempted only after a reasonable degree of macro-economic stability has been attained; preferably, reforms should be gradual.

(ii) Where relative prices are distorted owing to protection or price controls, financial liberalisation by itself may not improve the allocation of resources, which is one of the stated objectives of such liberalisation; exchange rate realignments and reforms in

trade and public enterprise pricing policy should also receive due attention.

(iii) Direct intervention in finance should increasingly yield place to an adequate, if less cumbersome and invasive, system of laws and regulations concerning supervision and monitoring.

A growing and welcome trend in several developing countries is the diversification of banking activity into new financial services such as merchant banking, equipment leasing, mutual funds, housing finance, factoring and venture capital. This would broaden the financial system and enable it to meet the varied needs of economic agents. While social banking and social orientation of banking policy are important, the requirements of large-size manufacturing firms for new financial products and new forms of financing have also to be met. With modernisation and competitive environment nursed by manufacturing and service sector firms and with greater emphasis on export-import trade, the need for sophisticated banking services will be felt in all countries - small or big.

However, banks in developing countries have got to guard themselves against a situation of excessive competition and concomitant risks. The current international banking scenario provides us with telling lessons in this respect. With excessive competition, particularly in wholesale banking, and to some extent, with banks' involvement in risky lending in such areas as real estate, banks' profitability has been considerably eroded and even some top-notch international banks are reportedly unable to adhere to the 1992 deadline for meeting the eight per cent risk-weighted asset capital ratio. This underlines the importance of ensuring that the traditional caution in the spread of banking institutions and time-tested safeguards against excessive involvement in risky lending are duly exercised. It is noteworthy that alongside greater liberalisation of the banking systems, there has been an increasing emphasis on prudential regulation on the part of the central banks.

I have touched upon only a few issues germane to the banking scene, mainly of developing countries, against the background of the theme of **"Banking, Finance and Development"** which you will debate in the course of next 10 days or so. You have a select group of distinguished speakers who are scheduled to present before you major papers on the subject. As you would probably come to know then, India has also embarked, rather cautiously, on a course of financial liberalisation and innovation. Significant flexibility has been introduced in the operation of the administered interest rate structure. In fact, over 55 per cent of commercial bank lending has been freed from interest rate regulation except for a minimum rate prescribed. Deposit rates have been rationalised. Commercial banks have been encouraged to diversify, on their own or through their subsidiaries, into many new areas of business. Money market rates have been freed from interest regulations. New instruments with free and market-related yield rates such as commercial paper and certificates of deposits have been introduced. The number of institutions allowed to participate in the money market instruments like bills rediscounting and call money has been considerably expanded. The Discount and Finance House of India has been set up to facilitate the promotion of money market instruments. With greater emphasis on housing finance, the National Housing Bank has been set up at the apex level. Along with the impetus given to institution and instrument development, importance has been accorded not only to strengthening prudential supervision of commercial banks, but also to extending its scope to banks' subsidiaries.

With these words, I have great pleasure in inaugurating the First Afro-Asian Banking School. I wish your deliberations all success.