## Finance and Development – Which Way Now?

The Annual Foundation Lecture of this famous College is an important event in our country's academic calendar. Several of our most distinguished economists, public administrators and thinkers have shared their thoughts with you on this occasion. I feel privileged to have been invited to deliver this year's lecture. My happiness in being able to join you today has been immeasurably enhanced by the presence of Shri M. Narasimham at this function. Shri Narasimham's substantial contribution to monetary economics, public administration, academic institutions, the financial system, and international agencies are well known, and I do not wish to embarrass him by recounting these. Permit me only to say that if, in the aftermath of the East Asian crisis, we are able to take some comfort in our relative stability and the resilience of our financial system, it is in no small measure due to the guidance provided by him, particularly in his capacity as Chairman of two high level committees on financial sector reform. My personal association with him goes back nearly 30 years. I have learnt much from him and I have always admired his unfailing commitment to public service and his unflinching confidence in our country's future. Thank you, Mr. Narasimham, for inviting me here.

2. Since I received this invitation, I have been thinking about what I should talk about. After some consideration, and a great deal of trepidation, I have chosen to speak about finance and development, particularly where we are and where we should be going.[1] The role of finance in development has, of course, always been recognised. However, I believe that in the last few years, there has been a fundamental change in the way we think about the financial system and its role in development. Part of this change is due to the changing role being assigned to Government and public sector in the allocation of nation's savings for development. A more dramatic and recent reason for this change is due to the East Asian crisis. This crisis, and its aftermath, have brought to the fore the critical role of the financial system in determining the stability and sustainability of the real economy. As a result, the reform of the financial system, and the rules and the codes that should govern the conduct of financial business, figure high on the domestic agenda for reform as well as the international agenda for global co-operation.

3. I propose to begin this lecture with some reflections on the paradigm shift that has taken place in the literature as well as economic policy making on the role of finance in development. This will be followed by a discussion of some of the lessons emerging from the Asian crisis. I would then touch upon the evolution of the Indian financial system, and end with some reflections on future directions.

### I. Finance and Development – The Shifting Paradigm

4. In less than four weeks, we will be celebrating the dawn of a new millennium. As we reflect on the history of human civilization in the millennium just ending, it is surprising to recall just how recent is the story of economic growth. As Paul Krugman has noted in a recent book, "economic growth, at least economic growth that raises living standards, is a modern invention. From the dawn of history to the eighteenth century, the world was essentially Malthusian. Improvements in technology and capital investments were always overtaken by population growth; the number of people slowly increased, but their average standards of living did not."[2] Up to about the end of the 19th century, the only countries where per capita incomes were increasing on a sustained basis for any length of time were the Western countries, particularly, England, Germany, France and the United States. During this

entire period, the then so-called under-developed or Third World countries continued to be exporters of primary products and importers of industrial products with stagnant, and in some cases, declining per capita incomes. A large number of them were also colonies of the Western powers, and the connection between these two situations – the colonial state and income stagnation - was not missed by their leaders and intellectuals.

5. The development strategies of the newly independent and developing countries in mid-19$^{th}$ century were framed against this background. The central and the leading role for breaking away from the colonial legacy and for speeding up the process of industrialisation was assigned to the State. The need for the Government to occupy the commanding heights and to lead from the top received further support from the astounding success of the Soviet Union in emerging as a rival centre of political and industrial power within a very short period. India, at that time, played a pioneering role in giving expression to the aspirations of the newly independent Third World countries in the economic field. Thus, in 1956, India's Second Five Year Plan outlined the goals of development strategy in the following terms:

> " The pattern of development and the structure of socio-economic relations should be so planned that they result not only in appreciable increases in national income and employment but also in greater equality in incomes and wealth. Major decisions regarding production, distribution, consumption and investment – and in fact all significant socio-economic relationships –must be made by agencies informed by social purpose."

6. In practice, that meant, that all allocation decisions were to be made by the Government or its agencies. The importance of raising resources for development was, of course, considered important. However, the primary emphasis was to be on increasing the domestic savings rate by suppressing consumption, high taxation, and appropriating profits through ownership of commercial enterprises. Accelerated capital accumulation through these means was considered to be the key to development. In a celebrated observation which guided many a planner and policy maker in developing countries, Professor W.Arthur Lewis observed that:

> "The central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 to 5 per cent of its national income or less, converts itself to an economy where voluntary saving is running at about 12 to15 per cent of national income or more. This is the central problem because the central fact of economic development is rapid capital accumulation (including knowledge and skills with capital)." [3]

7. In the process of capital accumulation, the role of financial system was essentially limited, as allocation decisions were to be made by the central planning authorities and not by the financial markets. To a large extent, financial system also had a limited role in providing incentives for savings and capital accumulation as interest rates were controlled, and generally "repressed", and household savings were pre-empted through high levels of statutory reserve and liquidity ratio. New banks and financial institutions were set up, and old ones were taken over, in order to act primarily as deposit taking agencies and providers of credit and finance for designated and centrally determined purposes.

8. The above development paradigm has, of course, shifted rather sharply in recent years. Almost all developing countries are moving towards a more market-determined strategy of development. There are several factors which have contributed to this change in perception.

First and the foremost reason for questioning the earlier strategy was the simple fact that actual results in terms of growth of incomes or industrial development were well below expectations. Despite substantial increase in the domestic savings rates in several countries, including India, rate of growth of incomes was relatively low. While saving rates were rising, so were capital-output ratios because of inefficiencies in the allocation and use of resources. The period of relatively low growth also coincided with a period of virtually persistent and recurring balance of payments crises. Thus, paradoxically, a strategy which was expected to reduce dependency on foreign aid and foreign trade, actually resulted in greater dependence on aid and emergency assistance from abroad.

9. An equally important factor contributing to the change in perceptions was the astonishing success of Japan and the East Asian countries in accelerating their rates of growth by relying on market oriented pattern of industrialisation (with, of course, varying degrees of “guidance” by the State). Japan’s per capita rate of growth of 8 per cent per annum during 1953 – 1973 was unprecedented in the history of economic development. No economy had ever grown that fast before, and Japan emerged from the ruins of war to become the world’s second largest economy. Similar was the record of industrialisation in East Asia particularly in countries like Hong Kong, Singapore, Taiwan and South Korea. In the 50s, their per capita incomes or the degree of industrialisation was no different from those of the rest of Asia. However, within a period of 30 years, they were able to catch up with the industrialised countries of the West. A final and decisive development leading to the demise of the old strategy was the collapse of the Soviet Union and the acceptance of market-led development strategies by all countries of Eastern Europe.

10. The change in the development paradigm also led to a change in the perception about the role of the financial system in development. It became clear that liberalisation of product markets also requires a well functioning financial system for mobilisation and allocation of savings. Banks, capital markets and financial institutions were no longer seen as mere conduits for channelling savings in predetermined directions, but as important instruments for allocating savings among alternative investment choices according to their relative efficiency.

11. In the more recent period, after the onset of the East-Asian crisis in mid-1997, there has been a further change in the perception about the role of the financial system in development. Earlier, the real economy was supposed to lead and shape the financial system. Today, it is the real economy which is supposed to have become a prisoner of a weak financial system. In other words, proper development of the financial system is no longer regarded as an “ancillary” or an adjunct to the development of the real sector, but as a necessary pre-condition for growth.

12. The above developments in the real world were supported by findings in the theoretical literature which demonstrated the critical role of financial system in the growth process. The financial liberalisation literature developed in 1970s and 1980s stressed the costs of “financial repression”, particularly interest rate and exchange rate controls which restricted growth of financial intermediation and the real rate of economic growth. These findings were buttressed by the emergence of endogenous growth literature, which emphasized the importance of financial market as a source of innovation and productivity growth. It was demonstrated that an efficient and well functioning financial system contributed to economic growth by raising the level of saving and investment and the productivity of capital.

13. The change in the perception about the role of financial system in development has been

combined with a fair amount of debate on the nature and characteristics of financial markets as distinguished from products or factor markets. Are financial markets special? Do they require a different set of regulatory or supervisory regimes? What are the relative roles of international and domestic institutions and supervisory regimes in ensuring the viability and the integrity of the financial system in a particular country in the context of globalisation or "globality", as some prefer to call it?

14. Financial markets indeed have certain special characteristics. The most important of these is the large volume of transactions and the speed with which financial resources can move from one market to another, and from one instrument to another. A related characteristic is the scope for instant "arbitrage" as between different markets and between different types of instruments. Financial transactions can be highly leveraged and the risk of failure can be transferred by actual decision-makers to innocent by-standers.

15. Another interesting characteristic of these markets is the role of financial intermediaries. There are segments of financial markets, such as stock markets, and bond markets where savers themselves make the decision about when and where their money can be used. Markets are, however, also dominated by financial intermediaries (such as banks, provident funds and pension funds, mutual funds and so on), which take investment decisions as well as risks on behalf of their depositors. Yet another important characteristic of financial markets is the so-called "negative" externalities associated with them. A failure in any one segment of these markets may affect all other segments of the market, including the non-financial markets.

16. Financial markets are also highly susceptible to "self-fulfilling" prophecy or expectations. Sometimes "self-fulfilling" expectations can lead to panic as behaviour of a limited group of operators gets generalised. Jagdish Bhagwati has described the classic case of a self-fulfilling prophecy with reference to the behaviour of exchange rates dating back to the 1960s. Let me quote from an old article by him where he illustrates this particular feature of the foreign exchange market:

> "Let the objective reality initially be that the dollar will not depreciate. But suppose that speculators expect the opposite, and move out of the dollar, depreciating it. If the reality were independent of the actions of the speculators, the dollar would go up again, and the market would have chastised and ruined the speculators. But it may well be that as the dollar falls initially with the speculation, wages and hence prices rise in sympathy. If so, the objective reality would itself have changed, legitimating the devaluation of the dollar in view of the speculation-induced rise of prices. Such self-justifying speculation shapes its own reality."[4]

17. In view of the externalities, volatility and certain other special characteristics, it is generally agreed that financial markets have to be closely monitored and supervised. It has also been the past experience that, in view of the growing integration of worldwide financial markets, failure and vulnerability in the domestic market in a particular country can have international implications. Similarly, problems in the external markets can create difficult problems for the functioning of the domestic markets, even if the country concerned was following prudent macro-economic policies. This close relationship between the two markets, domestic and external, raises the question of appropriate duties and responsibilities of domestic supervisory authorities and international financial institutions.

18. Most of these issues have come to the fore in the context of the East Asian crisis and subsequent developments in certain other countries, such as, Russia and Brazil. Let us briefly look at the lessons emerging from recent developments in East Asia and elsewhere.

**I I. Lessons from the Asian crisis**

19. Much has been said and written about the causes of the Asian crisis and its aftermath. The literature is voluminous and growing by the day. In some ways, it is as impressive as the earlier literature on the "Asian miracle", and raises the obvious question of what developing countries must learn from their successes. It is not my purpose to review this literature nor to comment on what went wrong and what policies could have been handled better either before or after the crisis. My purpose is limited, and confined to recapturing some aspects of the Asian crisis which may have a bearing on our understanding of the relationship between finance and development, and the lessons that countries like ours need to keep in view in order to avoid having to go through similar devastating experiences in the future.

20. An important point to remember in this connection is that even relatively small mistakes in the conduct of macro-economic or exchange rate policies can sometimes lead to big crises. The Asian experience is certainly mixed, and the magnitude of macro-economic and other policy failures in different East Asian countries was not the same. However, in several of them, the degree of deviation from the best practices or prudent policies was relatively small. It may be that they persisted with the defence of the pegged exchange rates for a week or two longer than was desirable, or it may be that they did not take corrective monetary or fiscal action early enough. However, the devastation and the pain that their economies went through because of these policy mistakes were sizeable and unprecedented.[5] This, incidentally, was also the experience of Mexico and Argentina in early 1995, when a major emerging crisis was brought under a semblance of control by a massive international rescue effort launched by the IMF, the United States and the World Bank. It is no coincidence that in all these cases, in East Asia as well as in Mexico and Argentina, the proximate cause was the relatively sudden reversal of capital flows on which these economies had become excessively dependent. It had taken a relatively long time to build a climate of confidence, and for capital inflows to rise gradually. However, it took no time for this confidence to be dissipated and for foreign capital to disappear. It is also interesting to note that the major reversal was not only on account of foreign lenders or investors, but also on account of resident holders of domestic assets who rushed to encash or convert their holdings into foreign currency.

21. The point is simply that handling capital flows is not an easy business. While capital account liberalisation and large capital movements have brought considerable growth benefits, they have also brought with them greater potential for volatility in asset prices and financial markets, including forex markets. This can cause unanticipated damage to the real economy during periods of uncertainty about the future economic or political outlook. As mentioned earlier, adverse expectations about a country's future during periods of uncertainty can often become "self-fulfilling". The fact that such volatility can be aggravated by a weak financial system, leading to severe development problems, has also to be borne in mind. The lesson from the Mexican or East Asian episodes, I must emphasise, is not an argument against capital flows or capital account convertibility. It is about careful and judicious handling of such flows and about the pace of movement towards capital account liberalisation for residents. It is also about building domestic safety nets, for example, by keeping the level of liquid foreign exchange reserves high in relation to short term external obligations.

22. It can not be denied that, despite the earlier spectacular successes, the financial systems of East Asian countries were characterised by several weaknesses. Thus, banks were not subject to effective prudential regulation and supervision. Credit expansion in these countries was large and banks took untenable positions in real estate and other unproductive assets, in the process building up large asset-liability and currency mismatches. Banks had also built up huge off-balance sheet liabilities, which moved on to the balance sheet once there was adversity. Cross-border interbank positions were also large. Non-banking financial companies contributed to the crisis as these were subject to little or no regulation.

23. Corporates were also highly leveraged. External debt was available at low interest rates and the fixed exchange rates in these countries offered them a false sense of complacency, encouraging them to hold large unhedged positions. External debt was high, short-term, leveraged and concentrated in the private sector. Thus, on the whole, there was an inherent vulnerability in the financial sector, and once expectation turned adverse, this vulnerability easily translated itself into a panic. Standards of accounting practices, financial reporting and disclosure norms were somewhat inadequate in these countries. There was lack of transparency in the operations of market participants as well as the central banks in some cases.

24. Events in East Asia have certainly highlighted the two-way interaction between the financial sector and development and the need for an appropriate policy framework. Improving the efficiency of financial sector through market based reforms is an important concern of the new development paradigm. However, this has to be accompanied by policies, practices and certain amount of restraints that strengthen the financial system towards stability so that growth becomes sustainable. At the same time, proper emphasis has to be placed on growth policies that do not give rise to problems that engender systemic instability in the financial sector (e.g. a large fiscal deficit).

25. A related issue is that of striking an appropriate balance between financial regulation and market freedom. While freedom is essential to foster efficiency, it also raises an equally important question of an appropriate regulatory framework given the wide divergence between private and social interest in ensuring the stability of financial system. Hence, a proper system of regulation relating to prudent risk limits, short-term foreign borrowing and the degree of tolerable maturity mismatches in the banking system assumes critical importance for minimising risks to the stability of the financial system.

26. The most important lesson emerging from the Asian crisis, in my view, is the need to be vigilant about domestic and international developments which may impinge on a country's financial relations with the rest of the world. The process of integration of worldwide financial markets has resulted in product innovation and greater efficiency, but it has also made developing countries subject to greater vulnerability and new risks. Strong fundamentals alone cannot provide full immunity from a crisis. There is a need to take preventive early action, to build firewalls, and to keep some safety nets handy. It is also clear that when things are going well, the rest of the world shares in the prosperity. However, when things go wrong, the price has to be paid primarily by the country concerned. It is, therefore, an important responsibility of the countries themselves to put in place an efficient, prudential and safe financial system which can aid and protect the development process at all times – good and bad.

## I I I. The Indian Experience

27. Against the backdrop of the lessons from the Asian crisis, let us now turn to financial sector reforms in India from the perspective of our past experience, the present stage of development and some issues for the future.

*ThePast*

28. As mentioned earlier, our development strategy for nearly forty years or so after independence, placed emphasis on state guided development initiatives, with primary role assigned to the state and its agencies for mobilisation and allocation of savings. It was not until the Eighth Plan that the role of the financial sector and financial markets was given an explicit recognition in the development strategy. The emphasis on accelerating investment rate through state intervention in a number of key areas meant channelling credit to certain preferential sectors at subsidised interest rates, exercising public ownership control on banks and restricting their activities through policy prescriptions. Some of the typical features that got built into this system were the directed lending programme with high levels of cash reserve ratio and statutory liquidity ratio, ceiling on deposit and lending rate, lending to priority sectors, branch licensing, and detailed regulation of banks' loan and investment portfolios.

29. As far as external finance was concerned, India relied primarily on bilateral and multilateral official development assistance and did not encourage private external capital inflows as a way to supplement domestic savings. The exchange rate was administered and there was extensive control over all foreign exchange transactions, which were subject to approval on a case-by-case basis. Because of pervasive exchange controls, the Indian financial system remained largely insulated from international markets. This, however, did not prevent India from suffering regular balance of payments crises year-after-year and becoming dependent on aid flows or credits from the IMF.

30. The financial system, as a result, faced little or no competition, either domestic or foreign, and costs and efficiency of transactions were not its primary concern. Productivity was generally poor and profitability low. The system was also subject to limited accountability. By the beginning of 1990s, it was becoming evident that the system could not be sustained without a thorough revamping of its operations.

31. The balance of payments crisis in 1990-91 provided the trigger point of reform in several sectors, including the financial sector. The reform initiatives in financial sector started with Government appointing two committees: one on balance of payments under the chairmanship of Dr. C. Rangarajan, which went into liberalisation of policies in external sector and the second, on the financial sector under the chairmanship of Shri M. Narasimham, which deliberated on domestic financial sector reforms. The reform programme in financial sector since 1992 has largely followed the broad approach set out by these two committees, supplemented by the Second Narasimham Committee, which was set up in 1997.

*The Present*

32. What has been our progress in financial sector reform and what are our achievements so far? In so far as the "arithmeticals" of reform in the financial sector – to use a phrase used by the Narasimham Committee – is concerned, significant progress has been made in the past few years. There has been a steady decline in the level of resource pre-emption from the

banking system. Both cash reserve ratio and statutory liquidity ratio have been reduced from their high levels of 15 per cent and 38.5 per cent, respectively, in 1991-92 to 9 per cent and 25 per cent now. Interest rates in various segments of financial markets have been deregulated in a phased manner. This had preceded the abolition of control on capital issues and freeing of interest rate on private bonds and debentures. While the government borrowing rates are now market determined, there has been a gradual phasing out of interest rate subsidies on bank loans. Wide-ranging reforms have been initiated to develop and deepen the government securities market, money market, capital market and foreign exchange market. The Bank Rate has been reactivated, regular short-term Repos at a pre-announced rate are being conducted, and a system of prime lending rate has been introduced to provide direction to movement of interest rates in the credit market.

33. In the sphere of external financial policy, while the exchange rate is market determined, over the years, there has been a progressive liberalisation of foreign direct and portfolio investment, and approval procedures have been considerably simplified. As a result, there are now minimum restrictions on inflow of capital into the economy, or its repatriation and servicing. There has also been a significant liberalisation of policy regarding industry's access to foreign equity and borrowing through long term debt instruments. The banking sector has been given a greater degree of freedom with regard to raising funds abroad and managing their external liability, subject to prudential guidelines. The end result of all these and other reforms has been the growing integration among various segments of financial markets, closer convergence of Indian financial system with practices prevailing in international financial markets, and greater opportunity for investors to access both domestic and international markets. At the same time, care has been taken to avoid excessive short term external liability and asset-liability mismatches.

34. Competitive condition in the banking industry has been facilitated by relaxing entry and exit norms and permitting the public sector banks to raise additional capital from the market (up to a certain level). While public sector banks continue to be predominant, the changing competitive environment in the banking sector has made a significant difference to banking practices and disclosure requirements.

35. Prudential regulation and supervision have formed a critical component of the financial sector reform programme. India has adopted international prudential norms and practices with regard to capital adequacy, income recognition, provisioning requirement and supervision. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Recently, the required capital adequacy ratio has been increased to 9 per cent, from 8 per cent, in the banking sector. The mark to market practice for valuation of government securities has been gradually enhanced from 30 per cent in 1992-93 to 75 per cent by 1999-2000. Further refinement, in line with international best practices, in valuation and classification of investments by banks is currently under consideration. As a further prudential measure against credit and market risks, risk weights have been made applicable to government and other securities to take account of price variations.

36. An attempt has also been made to avoid the problems arising from "connected lending". There have been regulations that limit the exposure of individual banks and non-banking finance companies to any particular borrower or groups of borrowers. There are restrictions on banking system's exposure to equity and lending against equity as collateral, and its exposure to real estate is very limited. Prudent limits have been placed on the financial

system and the corporate sector as far as external borrowing is concerned.

37. In the area of supervision, a full-fledged institutional mechanism has been developed keeping in view the needs of a strong and stable financial system. The system of off-site surveillance has been combined with periodical on-site supervision for monitoring the risk profile of banks and their compliance with prudential guidelines. The Basle Core Principles for Effective Banking Supervision is substantially being adhered to. A "CAMELS" based rating system for Indian banks has also been introduced. The Reserve Bank's regulatory and supervisory responsibility has been widened to include financial institutions and non-banking financial companies.

38. As a result of these and other measures, some progress in the performance of the Indian banking system in recent years is noticeable. The trend in erosion of profit and capital base has been reversed. The net profits of the public sector banks, as a percentage of their total assets, averaged 0.4 per cent during 1994-95 to 1998-99, against the loss of about 1.0 per cent in 1992-93 and 1993-94. The gross non-performing assets of public sector banks (without allowing for provisions) as per cent of total assets have declined from about 12 per cent in 1992-93 to about 7 per cent in 1998-99. As of March 1999, all public sector banks except one had achieved capital adequacy ratios exceeding the prescribed norm of 8 per cent. Currently most of them are on the threshold of the prescribed 9 per cent ratio by March 2000. The improved performance has enabled most of the banks to meet their capital requirement from internal resources and the market without dependence on budgetary support.

39. The consolidation of financial system in the recent years has led to increased resilience of the Indian economy to external crisis. This has been evident from the muted impact of the Asian crisis on the Indian financial markets. Since then there has been a constant effort to enhance the regulatory and supervisory standards in conformity with international standards.

40. To sum up, it is clear that, thanks to the guidance provided by committees headed by Dr. Rangarajan and Shri Narasimham, there has been significant progress in broadening and strengthening of India's financial system. The task is, however, far from complete. Let us briefly look at some of the areas which require priority consideration in the future.

*The Future*

41. The agenda for future is long. Fortunately, there has been a widespread interest and debate among experts and market participants on various aspects of financial reform which has enabled India to chart out a path which is best suited to our conditions. Limitations of time - and of your patience – do not permit me to cover the entire agenda for the future.[6] I will, therefore, confine myself to highlighting only a few areas which, in my view, deserve priority.

42. First and foremost, it is necessary to continue with the process of strengthening our prudential, provisioning and capitalisation norms and bring them in line with best international standards. It is equally important to continue with our efforts to introduce maximum transparency, disclosure, and accountability so that investors and counter parties to financial transactions can take their decisions based on full information and their own assessment of market and other risks. Tighter and tougher prudential standards will no doubt cause some pain and impose greater responsibility on banks and other financial institutions. However, as I mentioned before, given the new international focus and externalities and

linkages involved, the regulation of the financial sector is no longer a matter of choice or a matter of domestic concern alone. Over a period of time, it is likely that the willingness of the rest of the world to do financial business – either by way of trade credits, direct investments or other types of investments and loans will depend on their confidence in our financial practices. India must remain ahead of the curve in its prudential management.

43. The level of Non-Performing Assets (NPAs) of the banking system in India has shown an improvement in recent years, but it is still too high. Part of the problem in resolving this issue is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful. The Narasimham Committee and the Verma Committee (which recently submitted its report) have looked into the problems of weak banks and have made certain recommendations which are under consideration of Government and the Reserve Bank. These are also being widely debated, so that an acceptable long-term solution can be evolved. Leaving aside the problem of weak banks, in profitable banks also, the NPA levels are still high. A vigorous effort has to be made by these banks to strengthen their internal control and risk management systems, and to set up early warning signals for timely detection and action. The resolution of the NPA problem also requires greater accountability on the part of corporates, greater disclosures in the case of defaults, and an efficient credit information system. Action has been initiated in all these areas, and it is hoped that, with the help of stricter accounting and prudential standards, the problem of NPAs in future will be effectively contained.

44. The problem of NPAs is also tied up with the issue of legal reform. This is an area which requires urgent consideration as the present system, involving substantial delays in arriving at a legal solution of disputes, is simply not tenable. It is hoped that recent efforts, such as establishing more Debt Recovery Tribunals and setting up of Settlement Advisory Committees in banks, would help. However, there is an urgent need to institute a proper legal framework to ensure expeditious recovery of debt and give adequate legal powers to banks to effect property transfers. The absence of quick and efficient system of legal redress constitutes an important "moral hazard" in the financial sector as it encourages imprudent borrowing.

45. In order to allow for growth in their assets in line with real growth in the economy, banks and financial institutions would need to increase their capitalisation quite substantially in the next few years. At present, the minimum shareholding by the Reserve Bank in the State Bank of India, prescribed by legislation, is 55 per cent. The minimum percentage of shareholding by Government in public sector banks is 51 per cent. So far, a number of strong banks have been able to access capital markets to meet their capitalisation requirements in line with prudential guidelines. Some of these banks, including SBI, now have limited scope to raise further capital from the market within the prescribed floor of RBI and Government shareholdings. If the risk weighted assets of these banks grow in line with the growth in the economy in the next five years, additional capital requirements of these banks may exceed Rs.10,000 crore. As against this requirement, the headroom available for these banks to raise capital from the market is less than Rs.1,000 crore. After allowing for additional infusion of reserve capital through internal generation and access to subordinated debt, the gap between their additional capital requirement and the leeway available to raise capital from the market will still remain quite sizeable.

46. In this situation, an issue that needs to be debated and resolved is whether this gap should be filled by contribution from the Reserve Bank (in the case of SBI) and Government (in the case of other public sector banks) or whether legislative ceiling for capital to be subscribed by the public should be raised. The provision of additional capital by the Reserve Bank is tantamount to additional monetisation, and its monetary impact is equivalent to that of printing additional currency. Contribution to banks' capital by the Government has a similar effect as it will add to Government's deficit, which is already very high. Government, in any case, would need to provide additional capital to weak banks, which are not in a position to raise capital on their own. Does it make economic or fiscal sense to add to this burden further? On balance, there seems to be a strong case for raising the legislative ceiling for market participation in equity capital of public sector banks.

47. At the same time, it has to be recognised that in our situation, particularly in view of the need to give adequate attention to agricultural credit and rural banking as also to maintain public confidence in the safety of banks, the public sector character of these banks should not be given up. Keeping these considerations in view, i.e., those of allowing greater access to markets while at the same time maintaining the public sector character of banks presently owned by the Government or the Reserve Bank, it may be necessary to prescribe a maximum (at a suitably low level) for shareholding by any single individual or a corporate in public sector banks. Government may also retain the pre-emptive right to appoint, if itn wishes, the Chief Executive and the majority of the Board members in public sector banks.

48. Over the years, progressive liberalisation of financial markets and institutional reforms have led to growing inter-links among various segments of financial markets. The emergence of different types of financial intermediaries, in addition to banks and financial institutions, is healthy and desirable. A diversified structure contributes to greater stability of the financial system in the event of unanticipated problems. Part of the reason why problems in Japan's financial sector have persisted for so long is believed to be due to virtually "Bank-only" financial intermediation[7]. In India, while there has been progress in developing various segments of the markets including money and debt markets, the depth of these markets remains low and the volumes as well as number of participants are not very large. An important priority for the future is to develop the depth and breadth of these markets and to allow multiplicity of intermediation possibilities with different risks and leverage profiles. RBI will continue to work with financial experts and market participants to develop an appropriate procedural and policy framework to move in this direction.

49. We also have to devise measures to make our interest rate structure more flexible in order to take account of changes in economic cycles and the inflation outlook. At present, for reasons which were highlighted in the Mid-term Review of Monetary and Credit Policy in October 1999, there are several constraints which limit the flexibility of interest rates in the banking sector as well as the rest of the financial sector. Given the fact that some of these constraints are deeply embedded in historical practices, consumer preference and public sector requirements, it may take some time to fully meet this objective. However, the process should begin now.

50. The above are just a few priority areas which require consideration. These are by no means exhaustive. I believe that if we get these right, it would make movement in other areas of financial reform speedier and easier.

## IV. Conclusion

51. I would like to conclude with a few observations on the second-half of the title of this lecture, i.e., “Which Way Now?”. At the beginning, as you would recall, I had discussed the changing perceptions about the role of finance in development in recent years. The change in the development paradigm from a largely state-directed strategy to a market-oriented one, and the unsatisfactory results of the earlier strategy, highlighted the role of the financial system in efficient mobilisation and allocation of a society’s savings. All over the developing world, in the last few years, there has been intense activity in reviewing the structure of the financial markets and taking measures to liberalise and broaden them.

52. Against this background, and against the background of past dissatisfactions with the old strategy, it is interesting to note that the record of development in the nineties has been a highly disappointing one for the developing world as a whole, with two important exceptions – India and China. The nineties – the period of the triumph of capitalism and financial liberalisation - has seen a growth rate of only 3.2 per cent in world output which is lower than the average of 3.9 per cent in the 70s, and not much different from the rate of growth of 3.4 per cent in the 80s. This period has also been a witness to a large number of currency crises (from the ERM crisis in Europe in the early part of the decade to the Mexican, Russian, Asian and the Brazilian crises recently); substantial swings in exchange rates (including the exchange rate of two leading currencies – the dollar and the yen); run ups in asset prices followed by sharp collapse (for example, in Japan, Nordic countries and Asia); and banking crises in almost all the regions of the world.

53. My purpose in drawing your attention to this rather disheartening record is not that we should now return to the old failed strategy. Nor is it to suggest that financial liberalisation or development of the financial markets are unnecessary. The old strategy collapsed under the weight of its own excesses and contradictions. Similarly, there is no doubt that financial reform and liberalisation of markets are necessary, essential and desirable to derive the maximum advantage from the momentous changes that are taking place in technology, international movement of capital, and comparative advantage of nations. My purpose in highlighting some of the problems that have emerged in the world economy in the 90s is to underscore simply one point, and that is that we must not confuse “means” with “ends”. Financial reforms and liberalisation of markets are the means to an end, and not ends in themselves. The final objective of a successful development strategy remains what it has always been – a sustained and rising income for all the people, and removal of poverty, deprivation and illiteracy within a reasonable period of time.

54. While we must remain steadfast in our pursuit of financial sector reforms, the success of this process should not be viewed from the angle of how much freedom it allows to the market players. The real test is how much benefit all this brings in terms of development, including greater employment opportunities and poverty alleviation for those who do not participate in the markets. It will also be wrong to view financial reforms as antithesis of Government’s role in development or the role of public policy in widening social choices and opportunities. In developing countries, with massive illiteracy and underdevelopment of infrastructure, Government will continue to have an important and crucial role in creating the necessary conditions for growth through investments in areas, such as, education, health, water supply, irrigation and infrastructure, etc. These and similar tasks cannot be fully taken over by the market. Successful financial reforms must result in strengthening the ability of governments to do what they need to do by helping to generate higher growth, higher revenues and higher productivity. In developed countries, the so-called “potential output” of

the economy, whatever its estimated level, can be left to be realised by changing the parameters of financial and monetary policy. In developing countries, the main challenge is to raise the level of potential output by removing the constraints of infrastructure and low human resource development.

55. Which way now? Alongside financial reform and development of markets, I would urge that the country's attention must also turn to fiscal empowerment of the state and improvement in public administration. This College has contributed enormously to inculcating a public service culture in our country, and to train civil servants in the highest traditions of service to the nation. Yet, more than 50 years after Independence, who can deny that our public offices, including public sector institutions, leave a lot to be desired in delivery of services or in the efficient discharge of essential functions? A thorough-going review of our institutional framework, rules, regulations, and accountability of the administrative organs of the state is now essential. The focus has to be on what they do for the people, and not on what they do for themselves. If our public institutions, including those in the field of education and health, are unable to overcome their inertia, then alternative modalities have to be found by Government for delivering these and other services.

56. Many of the functions of the state are now left undone or inefficiently done because of financial stringency at the Centre as well as the States. The dependence on borrowings to finance even essential expenditure has been increasing year after year leading to a vulnerable and unsustainable fiscal situation. Without adequate finance, the state cannot fulfil its developmental role or remove the constraints to country's potential output. Pioneering work has been done by our research institutions, as well as by Central and several State Governments, to identify measures that need to be taken to reinvigorate the fiscal system. We must move decisively in this direction without loss of time.

57. With a revitalised fiscal situation and further progress in establishing a forward looking, strong and stable financial system, the first century of the next millennium can truly be a century of development.

Thank you.

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I am thankful to Shri M.S.Mohanty and Dr.A. Prasad of the Reserve Bank of India for their help in the preparation of this lecture.

[1] The title of this lecture has been inspired by an address delivered by Dr.Amartya Sen in 1982 in Dublin, "Development: Which way now?". See Economic Journal, December, 1983.

[2] Paul Krugman, The Return of Depression Economics, The Penguin Press, London, 1999.

[3] W.A.Lewis "Economic Development with Unlimited Supplies of Labour", Manchester School, Vol. 22, 1954.

[4] Jagdish Bhagwati, "Wheel of Fortune", New Republic, October 5, 1987. Reproduced in A Stream of Windows - Unsettling Reflections on Trade, Immigration, and Democracy, The MIT Press, Cambridge, 1998.

[5] For a recent review of the situation in East Asia after two years of the crisis, see P.S. Jha, "South East Asia and the Future of the Global Economy", World Affairs, New Delhi, July - September, 1999.

[6] For a review of the present position and future agenda, please see Dr.Y.V. Reddy's address on, "Financial Sector Reform: Review and Prospects", reprinted in Reserve Bank of India Bulletin, January 1999. For a recent review of financial sector issues by experts, see J.A.Hanson and S. Kathuria, "India: A Financial Sector For the Twenty-first Century", Oxford University Press, Delhi, 1999.

[7] Remarks by Alan Greenspanata World Bank–IMF Seminar on September 27, 1999, Washington D.C. (mimeo).