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Thank you. I am, as ever, delighted to be in India. I am only sorry that on this occasion my visit is so brief.

I am here in Delhi specifically to attend your conference this morning. I was glad to have the opportunity to address such an important topic and I am grateful to the organizers for persisting with their invitation even when getting here did not seem logistically possible. As you can see, it was—just!

A strong, well-functioning financial sector is crucial for any economy—be it industrial, emerging market, or even low-income. It is essential for healthy sustained growth. As an economy grows and matures, its financial sector must grow with it. It must be able to meet the increasingly sophisticated demands that are placed on it.

I want this morning to consider why the financial sector plays such a crucial role in fostering sustainable economic growth; to look at how financial institutions must adapt as economies mature; and to look at the challenges that India's economic development poses for the banking system here.

The importance of a well-functioning financial system

For centuries we have known that even the most primitive economy needs a medium of exchange. In a largely rural economy, with only a small manufacturing sector, the demands for financial intermediation via banks and others for financing mechanisms are modest.

But as economies grow and diversify, their agricultural and manufacturing sectors expand, and their services sectors develop and grow, their banking sectors need to keep up. Decisions as to which activities to finance and which not are crucial for rapid growth. Growing economic complexity is, of course, an inevitable consequence of growth. It means that the benefits of efficient credit allocation rise—that efficient credit allocation is financing investments where the payoff is highest. But it also means that the challenges for those assessing alternative loan applicants mount. They must develop means of allocating credit among competing needs. They must learn to assess business plans and identify and manage risk.

The industrial revolution of the eighteenth and nineteenth centuries, and the rapid rise in economic and financial complexity seen in Western Europe and the United States, was a valuable learning experience. Successive banking crises in the 19th and 20th century served to underline the need for a well-functioning financial sector. Financial crises interrupt growth, or at least result in growth rates below potential. And governments and banks learned the importance of financial stability, and sound risk management. As Western economies developed, so, too, have their financial systems.

London's rise as the principal world financial centre in the 19th century reflected this—as well as London's superior ability to assess risk. And London's financial intermediation enabled faster growth in Britain, North America, South America and elsewhere than would otherwise have been possible.

But it is striking how further growth provides new challenges that must be met. Even sophisticated industrial economies continued to experience periodic banking sector problems—throughout the 20th century. Just think of the Great Depression or even the financial crises in Europe in the 1990s. It is easy to take a smooth-running, efficient financial sector for granted—and complacency in banking, as I am sure you all know, can be dangerous.

So we have seen financial structures develop along with economies. The history of the industrial economies of Europe and North America was one of financial strengthening and deepening in tandem with economic growth.

The earlier experience in the mature economies should have given the newly-industrializing countries of the twentieth century two important advantages. First, the contribution that a well-run financial system could make to economic development was more clearly, if still imperfectly, understood. And second, these rapidly growing economies should have been able to take advantage of sophisticated sources of finance available in the industrial economies.

In practice, it didn't work quite like that. Few of what we now call emerging market economies expended much effort in developing their financial systems in the first quarter century after the Second World War.

Many emerging market governments preferred to rely on directed credit as they attempted to pick winners in the drive to industrialize. Governments the world over find it hard to resist the temptation to show that they can do better than the market. Even some of the most successful emerging market economies continued to ration credit after growth started to accelerate—Korea springs to mind as an example.

And who can blame them? Industrial countries, too, continued to try to outperform the credit market—Britain, especially in the 1960s and 1970s, Japan,

France, Italy—I could go on: but, of course, the fraction of credit so directed was smaller than in emerging market economies. Even now, some European countries are reluctant to leave industrial credit entirely to market forces.

Yet there is plenty of evidence that government-directed credit does not achieve the intended results; it leads to a misallocation of resources, it reduces the overall return on capital and therefore has a dampening effect on growth. And the more sophisticated an economy becomes, the more harm that government rationing of credit can inflict.

Experience around the world has shown—repeatedly—that governments are not best placed to assess risk and economic potential in the private sector. And why should they be? Why should governments be able to determine which industrial sectors or firms will make the greatest contribution to economic growth? History in both developed and developing countries is full of examples of surprising success stories—of firms who could not attract government support, who found it hard to raise finance but who managed somehow to turn a profit and be successful.

Once potential lenders are convinced that their capital will produce a decent return, of course, they are happy to lend. And there will always be those willing to take a greater risk with their capital in return for the prospect of higher returns. The internet bubble of the late 1990s showed that the prospect of higher returns, however risky they might be, is a temptation some find difficult to resist.

Conversely, history is also littered with examples of government failures in this area. Who now remembers the Delorean car, given large injections of cash by the British government because it wanted to develop a car manufacturing base in Northern Ireland? Even in Korea, one of the great economic success stories of the latter part of the 20th century, governments were unable to resist trying to direct credit allocation: they ended directed credit support for the fledgling chemicals and other industries when it had become clear that this was not going to make a significant contribution to economic growth and was detracting from it.

Credit rationing causes problems for both banks and industry. After all, if it is the government deciding where credit should be allocated, private firms wanting to expand may be constrained from obtaining the finance they need—because credit is not being allocated on the basis of what loans will deliver the best return. Savings are deterred. Banks' profitability is lower because they are not able to lend what they want and where they want.

And when credit is rationed at low or negative real interest rates, banks naturally lend only to the safest of customers—which might not offer the highest returns. The experience of many countries with credit rationing showed that it kept high-cost firms in business and so lowered the overall return on capital. That in turn kept economic growth below its potential.

Recent experience

It was only the experience of the 1990s that finally brought home to us the central importance of a healthy financial sector—for economic stability and growth. We knew it, as I've already noted. But somehow we had continued to underestimate the significance of what we knew.

The Asian financial crisis of 1997-98 underlined the risks to economic stability and growth that a weak or vulnerable financial sector could pose. Korea is a particularly striking example of the extent to which financial sector weakness can undermine economic stability. From the 1960s, as you know, the Korean economy had grown at a spectacular pace. This growth had been driven by exports—3% of GDP in the early 1960s, 35% or more by the early 1990s. Korea had been the first emerging market economy to exploit the benefits of the international capital markets, in the 1960s.

But Korea's export growth had in part been fuelled by directed credit. To begin with the rate of return on capital was high; and since credit was directed mainly to exports, all went well. But the rate of return on capital subsequently declined, from about 3% over a long period, to a negative real rate of return in the 1990s, and this acted as a brake on economic growth. And significant contingent liabilities had been built up because of mis-matched exposures as a result of dollar borrowing because people had assumed the exchange rate would remain stable and had looked elsewhere for attractive borrowing opportunities. Once the financial markets recognized that the situation had become unsustainable, the crisis was inevitable.

The Japanese financial sector also experienced problems in the 1990s, because of the failure to clean up non-performing loans (NPLs) in the banking sector, a problem that has proved difficult to resolve. Non-performing loans seriously undermine the health of a country's banking system and can, indeed, threaten the stability of the entire financial sector. They handicap banks because they tie up assets that bring no return and, in many cases, no prospect of a return.

The experience of the recent past means that there really is no longer any excuse for overlooking the importance of a sound, well-regulated financial sector, of which the banking system is a crucial part. It is a *sine qua non* for macroeconomic stability and sustained growth.

The banking sector is crucial. But it should not be the only source of finance and credit allocation. As an economy grows in size and complexity, the financial sector must grow with it. It must become wider and deeper in order to spread risk. The more sources of finance, and the more sources of credit—and the greater the competition—the better placed the sector is to assess risk and potential rates of return. The more efficient credit allocation is, the more likely it is that credit goes to

where it will deliver the best return, so raising the potential growth rate of the economy as a whole. The better risk assessment and management, the better directed credit is, and the better-regulated the financial sector, the more resilient the economy as a whole will be to external shocks.

Economies need well-developed securities and equity markets. As firms grow in size, diversity and complexity, they need access to credit on the best terms; they also need access to different kinds of finance according to their needs. The ability to raise longer-term finance through equity or securities reduces firms' reliance on short-term bank finance that might make long-term investments vulnerable to shifts in interest rates. And citizens and institutions of different countries need to be able to hold each others' securities. This is a natural part of the process of global economic integration and can also reduce the concentration of risk in each country in any one sector.

So the role of domestic policymakers is clear. A healthy efficient financial sector is a vital component of economic growth. Putting the necessary measures in place to ensure the banking system is sound, that non-bank financial systems are well-managed, and that risk in the system is clearly identified, might not always be easy in the short-term. But such measures will undoubtedly bring significant rewards in the medium and longer term.

Role of the IMF

The IMF has an important role to play here. Our central task, according to our mandate, is the promotion of international financial stability. That is not meant to be an end in itself, of course. A stable international financial system is a vital ingredient in promoting the sustained rapid economic growth that brings rising living standards and poverty reduction. International financial stability is essential for the expansion of trade that makes growth possible.

But international financial stability cannot be sustained if there is weakness at national levels. So nowadays we in the Fund pay ever closer attention to the health of the financial sector. We try to assess the robustness of the financial sector in a variety of ways. We pay close attention to banks' balance sheets and the extent of NPLs. We also examine the extent to which risk is clearly defined in the financial system as a whole. And we look at the degree of competition within both the banking system and the financial sector as a whole: competition should improve the efficiency of credit allocation, it should also help diversify financial risk and cut borrowing costs. We look for mis-matched exposures since these can be a source of instability.

The breadth of financial instruments is also important; as is the transparency of the system which enables more accurate assessments to be made of the asset and risk position of individual institutions. And a strong, effective regulatory regime, following international best practice, is vital.

As part of the attempt to refine this process, the Financial Sector Assessment program (FSAP) was introduced in 1999 by the IMF and the World Bank. Some of you may be familiar with this. The FSAP program –which is a joint program with the World Bank when low-income countries are involved—aims to help member governments strengthen their financial systems by making it easier to detect vulnerabilities at an early stage; to identify key areas which need further work; to set policy priorities; and to provide technical assistance when this is needed to strengthen supervisory and reporting frameworks. The end result is intended to ensure that the right processes are in place for countries to make their own substantive assessments.

The work carried out under an FSAP program involves a broad range of financial experts, many of them from outside the Fund. Some come with substantial experience in regulating the financial sector of individual member countries; others are involved with international regulatory bodies. Still others have specific qualifications needed for the tasks involved. The aim is to bring powerful expertise to bear in a detailed examination of the financial system of Fund member countries.

Let me be clear. It is not the role of FSAPs to examine the balance sheets of individual banks, or even the banking sector as a whole. Their purpose is to help our member countries ensure that the correct framework is in place so that domestic regulators and supervisors are able to make accurate judgments about the health of the banks and other financial institutions under their jurisdiction.

A large number and a wide range of our member countries have now had an FSAP program. The feedback we get is overwhelmingly positive. Even the authorities in those industrial countries with highly developed financial sectors have found them to be useful.

The FSAP also forms the basis for Financial Stability Assessments (FSAs) in which IMF staff address issues directly related to the Fund's surveillance work. These include risks to macroeconomic stability that might come from the financial sector and the capacity of the sector to absorb shocks. Is the level of NPLs a cause

for concern? Are the banks well-regulated and sound? How would the financial sector be affected by sharp rises in interest rates—would this lead to a rise in NPLs? Again, these FSAs cut across the full breadth of our membership.

We have also worked with the World Bank to develop a system of Standards and Codes—using internationally-recognized standards—that result in the somewhat unimaginatively titled Reports on Standards and Codes (ROSCs). These cover twelve areas, including banking supervision, securities regulation and insurance supervision. The financial sector ROSCs are an integral part of the Financial Sector Assessment program and are published by agreement with the member country. They are used to sharpen discussions between the Fund—and, where appropriate, the World Bank—and national authorities; and, in the private sector, including rating agencies, for risk assessment purposes.

It is perhaps worth noting that some Fund research done last year suggests that there is a tangible payoff for member countries where the Fund has undertaken ROSCs **and** where the reports have been published in full. The markets take a favorable view of this transparency which can translate into lower borrowing costs.

Globalization

As I said earlier, the process of economic development is one in which an increasingly sophisticated and well-run financial sector has a key role to play. Economic growth has been accompanied and facilitated by efficient allocation of credit and risk. A healthy financial sector is necessary—though not sufficient—if economies are to be equipped to meet the challenges of globalization and to benefit from closer integration with the world economy. And as the world economy becomes more closely integrated, so, too, is the international financial system.

Globalization is not something that economies can opt into or out of, as Dr Reddy and others have observed. The drive towards closer economic integration has been going on for centuries—from the days of the early Mediterranean traders, Marco Polo, the Asian spice trade and the Industrial Revolution in Europe and North America in the 18th and 19th centuries.

Let us not forget that globalization has brought enormous rewards. And since the multilateral economic framework established in the 1940s, those rewards have increased still further. The spectacular expansion of international trade after 1945 helped make possible sustained rapid growth. Indeed the growth rates enjoyed by, first, the industrial countries and then later, developing countries, were without historical parallel. Just take one example: between the 1960s and the 1990s Korea

experienced per capita GDP growth that **each decade** matched what Britain had achieved in the whole of the 19th century. Industrial countries could not have had the standards of living that they now do without financial integration.

Sustained high growth rates are the only route to lasting, substantial and widespread poverty reduction. Accompanying rising material wealth have been dramatic improvements in the quality of life: as incomes rise, so do literacy rates and life expectancy; and infant mortality falls. In the past half-century alone, the gap between life expectancy in developed and developing countries has narrowed from around thirty years to about ten years today.

India's experience

In the first decades of the postwar era, India benefited less from globalization than some countries because the economy was less integrated into the world economy. Central planning and high trade barriers restricted India's growth rate—I'm sure many of you recall the so-called Hindu rates of growth of the 1950s, 1960s and 1970s.

But the reforms that started in the early 1990s transformed the picture. India has started to reap the benefits of globalization; and, of course, its slower start means there are many more benefits to be reaped. It is no accident that India's growth rate since 1991 has averaged around 6% a year—a significant step up from the growth rates achieved previously. In the latter part of the 1990s, India was one of the most rapidly-growing of the emerging market economies.

The gains have been large and immediate. Take poverty reduction. In the 1990s, some 200 million people around the globe were lifted out of poverty; and most of them were in India and China—two of the most rapidly-growing economies in the developing world during that decade—a direct result of both economies having started to open up to the rest of the world.

As you know, from 1991 there was a significant degree of deregulation in the Indian economy. Many of the reforms introduced were aimed at integrating India more closely with the rest of the world, and quite a number of those reforms directly affected you in the banking sector. Indeed, reform of the financial sector was a key part of the comprehensive program of reforms begun in 1991. There were significant changes in the banking sector, aimed at improving the supervisory regime, enhancing competition and the role of market forces and in technology. There were also important reforms in the government securities and foreign exchange markets with a rise in the number of instruments and more extensive use of hedging and swaps.

Rakesh Mohan recently argued that what made the financial sector reforms of the 1990s different than previous reforms was that they formed part of a well thought

out and comprehensive agenda of reform. He also noted that there has been no reversal of direction in the financial sector reform process in the past fifteen years.

Freeing up the domestic markets and starting to lower trade barriers has brought large and tangible gains for Indian business. Take the software industry, where India is now a world leader. Other examples—such as the growth of remote call centers—show how technological advances have helped create jobs here. And the improved functioning of the banking system has contributed to these successes and higher growth rates.

Indeed, India is well-placed to benefit much more from globalization. Because the economy was opened up later than many others, there are, as I noted, correspondingly greater benefits to come from further opening. There is still enormous untapped potential here and integration with the global economy will facilitate realizing that potential through, for example, more foreign investment, and more foreign competition. India has done well in exploiting markets for highly-skilled labor. But there is also a need for unskilled jobs, and more foreign investment could help meet that need.

I mentioned the reforms already undertaken in your own sector. This is an exciting time to be a banker in India—and that is saying something given the challenges facing bankers all around the world in the twenty-first century. As you know, the global banking industry is undergoing something of a revolution—driven in part by the pace of global economic integration but also driven by dramatic technological changes.

No longer is a bank a physical building that individuals and firms visit to discuss their financial needs. Banking has become a global business—and banks increasingly need to think globally if they are to be successful. They must assess risk; match exposures; and provide a full range of financial services because as firms grow bigger, and more diversified, so do their financial needs. Successful firms need to be able to compete at the global level, and they need correspondingly sophisticated financial services. Banks need increasingly to be able to respond to these demands.

So banks worldwide increasingly find themselves having to compete at the global level. That means an effective well-managed regulatory system for the banks and the financial sector as a whole is essential at the national level. It also means international co-operation among regulators is of increasing importance.

This is an area where I know Dr Reddy and his colleagues have worked hard to ensure the adoption of best international practice in areas such as banking supervision and standards and codes.

One important consequence of more rapid global economic integration is that reform has to be a continuing process. The reforms introduced in the banking sector in the 1990s were far-reaching. But the world of business and of banking is changing rapidly. Firms increasingly want a one-stop shop for their financial needs, and Indian banks need to be able to compete if they are not to lose business. At the technological level that need not be a problem—especially given that many foreign banks already rely on Indian expertise to run their back-office operations!

The Indian economy has made great strides in recent years. As I have argued elsewhere, I think India has the potential to do even better. [See *Letting the future in: India's continuing reform* agenda:Anne O Krueger, keynote address to Stanford India Conference, June 4, 2004: http://www.imf.org/external/np/speeches/2004/060404.htm). Given the right mix of policies, growth of something close to 10% is feasible. It is certainly needed, if rapid progress is to be made in extending the benefits of growth and rising living standards to all Indians. Sustained high rates of growth are the only route to lasting poverty reduction.

A successful, competitive and well-regulated financial sector is a vital part of the policy mix. Indian banks should be capable of competing with the best in the world. Given the size of the domestic market, it should be possible for Indian banks to become truly global players—and I look forward to that happening as part of the story of Indian economic development and closer integration with the rest of the world.

Thank you.