A healthy financial system is essential for progress

Guest Column
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The Indian economy is at a critical juncture in its growth trajectory. It is benefiting from market-oriented reforms that started in earnest 20 years ago. Now, after a decade of blazing growth, the economy is at an inflection point. Today's policy choices will determine whether this growth surge remains sustainable or fizzles out.

Finance holds the key to achieving India's long-term growth potential. As the economy becomes larger, more complex and market-oriented, the financial sector will play a crucial role in underpinning growth by channelling domestic and foreign capital into productive investments. Increasing access to the financial system is also a priority for making growth more balanced and sustainable, from both economic and social perspectives.

A system that provides credit, savings instruments and insurance to a broad swathe of the population is essential for distributing the fruits of growth more evenly.

Progress on financial reform has been uneven and slowed by the global crisis. Like many other emerging markets, India weathered the crisis far better than the advanced economies, with only a modest dip in growth. This has spawned two dangerous notions. First, that it is desirable to keep much of the banking system under state control as that makes the economy resilient to crises. Second, relatively insulated financial markets will protect the economy from outside shocks.

It is true that state-owned banks did better during the crisis, with stronger deposit growth and more credit expansion. A different interpretation is that, during a period of turmoil and uncertainty, deposits fled to banks that had implicit government backing and these banks were in turn emboldened and indeed encouraged to keep lending.

What is missing from the calculus are the long-term economic and social costs of a banking system that is inefficient and narrow.

Despite all the strictures they operate under, some government-owned banks have managed to compete effectively, holding their own against domestic and foreign private banks. It is time to cut these banks loose from government control and reduce barriers to the entry of new private banks.

As India continues to deepen its integration into world trade and finance, it will be more exposed to external shocks. Rather than going into a defensive crouch, the right approach is to manage the process of globalisation to the country's benefit while containing the risks.

Dependence on foreign capital certainly leaves an economy at the mercy of the whims of foreign investors. Despite India's sizeable war chest of foreign exchange reserves, the current account deficit of more than 3 per cent of gross domestic product is a serious concern.

At the same time, India has enormous financing needs, especially for rectifying its woefully inadequate physical infrastructure.

So, foreign capital is welcome but the question is whether the financial system can absorb these funds effectively rather than just fuelling asset bubbles and adding to macroeconomic volatility. Controls to limit surges in capital inflows are a seductive solution but they are largely ineffective.

Besides, the last thing India needs is policy uncertainty that frightens away foreign investors and causes financing problems.

Here again, financial market development is the answer. A broader set of markets can help absorb foreign funds and channel them towards more productive uses. For instance, the development of corporate bond markets would help channel foreign capital (and domestic savings) into long-term financing for infrastructure projects.

Opening up sectors such as the retail trade to foreign direct investment would also bring in more stable funds, along with technology transfers and the ancillary benefits of greater competition.

Greater urgency and the political will are needed to implement reforms when times are good. Otherwise, a golden opportunity will be lost

To the government's credit, financial reforms continued even during the crisis period. India has introduced currency derivatives, interest rate futures and even credit default swaps in a cautious manner with tight regulations.

The Reserve Bank of India has wisely resisted the introduction of capital controls and made it a priority to increase financial access. These steps are welcome but the broader financial reform agenda remains vast.

Moreover, finance does not operate in a vacuum. Institutional reforms and good macroeconomic policies are essential for a financial system to work well and deliver high growth. In addition to its corrosive effects, rampant public corruption scares away long-term foreign investors and shifts the composition of inflows towards more short term and less stable forms of capital.

Large budget deficits and the high level of public debt constitute another source of vulnerability. Roping in banks to help finance deficits by forcing them to buy government bonds makes a bad problem worse by imposing a huge cost on the banking system and crowding out lending to the private sector.

Unless the government can tackle these problems, they will erode India's growth potential.

The country's red-hot economy and growing importance on the world economic stage are huge achievements.

The danger is that triumphalism leads to stalling of reforms, or even some backsliding. What is needed is greater urgency and the political will to implement reforms when times are good. Otherwise, it will be a golden opportunity lost.

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