How to Fix India's Financial Sector

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India's financial system holds one of the keys, if not *the* key, to the country's future growth trajectory. A growing and increasingly complex market-oriented economy, and its rising integration with global trade and finance require deeper, more efficient and well-regulated financial markets. Today, India is some way from this ideal, and progress on reforms has been glacial, at best. But this is not an intractable problem.

Liberalize, liberalize, liberalize.

In fact, there is now a blueprint for fixing India's financial system and preparing it for the challenges of the future. Today, the High Level Committee on Financial Sector Reforms delivered its report to India's Planning Commission (see http://planningcommission.nic.in/reports/genrep/report_fr.htm). The report is the result of six months of intensive work by a select group of businessmen, academics and policymakers, including us. The committee was tasked by the government to articulate a vision for the next generation of financial reforms.

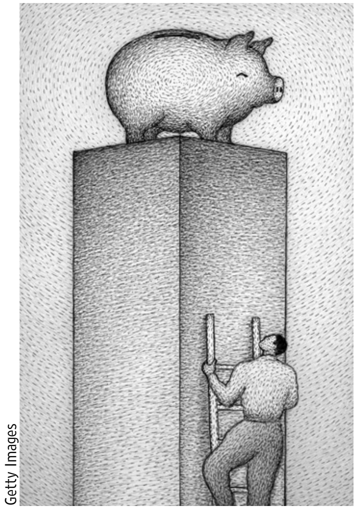
There have been numerous other government committees looking into specific aspects of financial reforms, but this is the first committee mandated to "outline a comprehensive agenda for the evolution of the financial sector." Indeed, the report shows that recognizing the deep linkages among different reforms, including broader reforms to monetary and fiscal policies, is essential to achieve real progress.

The report has three main conclusions. First, the financial system is not providing adequate services to the majority of Indian retail customers, small and medium-sized enterprises, or large corporations. Government ownership of 70% of the banking system and hindrances to the development of corporate debt and derivatives markets have stunted financial development. This will inevitably become a barrier to high growth.

Second, the financial sector—if properly regulated but unleashed from government strictures that have stifled the development of certain markets and kept others from becoming competitive and efficient—has the potential to generate millions of much-needed jobs and, more important, have an enormous multiplier effect on economic growth. Third, in these uncertain times, financial stability is more important than ever to keep growth from being derailed by shocks hitting the system, especially from abroad.

A robust financial system is not much good if most people don't have access to it. Financial inclusion is a key priority for India, especially rural India. This means providing not just basic banking but also instruments to insure against adverse events such as low crop yields due to bad weather. Nearly three-quarters of farm households have no access to formal sources of credit, leaving the rural poor especially vulnerable to moneylenders. The committee's analysis shows that nearly half of the loans taken by those in the bottom quarter of the income distribution are from informal lenders at an interest rate above 36% a year, well above the mandated lending rate for banks, which is less than half that level.

Government is part of the problem. At present, all banks must lend to "priority" sectors such as agriculture. They are also subject to interest rate ceilings imposed on small loans, which restrict rather than improve broad access to institutional finance. Banks have no incentive to expand lending if the price of small loans is fixed by fiat. The solution is not more government intervention but more competition between formal and informal financial institutions and fewer restrictions on the former.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With so many difficult challenges, how to proceed? Many of the required reforms are deeply intertwined. For instance, it would make sense to level the playing field between banks and nonbank financial corporations by easing the requirement that banks finance priority sectors and the government. But making these changes while the government continues to have huge financing needs, and without having a more uniform and nimble regulatory regime, could be dangerous.

Broader macroeconomic reforms could reinforce individual financial sector measures. For instance, allowing foreign investors to participate more freely in corporate and government debt markets could increase liquidity in those markets, provide financing for infrastructure investment and reduce public debt financing through banks.

India's political process being what it is, focusing solely on the big picture could bog down progress. Hence, the report also lists a number of specific steps that could get the process of reforms going and build up some momentum as people see the benefits. Many of these are less controversial but will still require some resolve on the part of policymakers to implement. For instance, converting trade receivable claims to electronic format and creating a structure to allow them to be sold as commercial paper could greatly boost the credit available to small and medium enterprises.

We believe that if other policies are synchronized, the implementation of our report's blueprint for financial sector reforms could add significantly to economic growth and also make a major contribution to the sustainability of this growth. The absence of reforms, on the other hand, would not only represent a lost opportunity but also a huge risk for the economy in the future.

Mr. Rajan, a professor of finance at the University of Chicago's Graduate School of Business, was the Chairman of the Committee on Financial Sector Reforms. Mr. Prasad, a professor of economics at Cornell University, was a member of the committee's research team.