

FINANCIAL SECTOR REFORMS AND STATE OF INDIAN ECONOMY¹

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Abstract

Indian economy has been recording impressive growth rates since 1991. This can be partly attributed to the multi-sector structural reforms aimed at enhancing productivity, efficiency and international competitiveness of the economy. The reforms in the financial sector have been most effective. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated. The reforms have been undertaken gradually with mutual consent and wider debate amongst the participants and in a sequential pattern that is reinforcing to the overall economy. The financial markets have developed and are more integrated after the reforms, and regulatory and supervisory institutions have been set-up. The reforms, though slow paced initially but well synchronized, have begun to yield results. The economy has recorded consistently high growth rates, avoided any adverse impact from the South East Asian crises, built substantial foreign exchange reserves, pre-paid some of its external debt and restructured its domestic debt.

The study is divided in two parts. The first part, which covered the rationale and need for reforms, and the developments in the fiscal policy, was published in December 2004. This part covers the developments in banking, external sector and financial markets.

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PART – II REFORMS IN BANKING, EXTERNAL SECTOR AND FINANCIAL MARKETS

The performance of the Indian economy in the last decade has been remarkably strong. One of the reasons for the robust performance of the economy could be the ongoing financial sector reform, which began in 1991. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially money and government securities.

There are different views about the role of financial development in economic growth. McKinnon (1973) and Shaw (1973) draw attention to financial markets and their role in economic growth, while Robinson (1952) argues that finance follows enterprise. In recent times, Rajan and Zingales (1998), based on a large sample of countries, find that financial development facilitates economic growth. In any economy, the financial system plays a major role in transferring financial resources from net savers to net investors. Levine (2004) concludes that the preponderance of evidence suggests a positive role for financial intermediaries and markets in economic growth.

In this part of the study, after having already covered the rationale for economic reforms and the developments in fiscal policy earlier, the objective is to document that the multi-sector reforms undertaken in India, though slow paced initially but well synchronized, have begun to yield results. This paper is mainly focused on financial sector reforms and is organized in five sections. In Section-I, the reforms in banking

sector are discussed. Section – II deals with the external sector reforms initiated in 1991 while reforms in the financial markets are presented next. The positive impact of the reform measures and the resilience of the economy are discussed in Section-IV. The conclusions that emerge and some proposed measures for the reforms to continue are discussed in Section-V.

SECTION I: BANKING SECTOR REFORMS

The Indian financial system comprises an impressive network of commercial banks (CBs), co-operative banks (CPBs), development finance institutions (DFIs) and non-banking financial companies (NBFCs). CBs are the most important segment of the financial system, with financial assets in 2003 accounting for 56.6 per cent of GDP followed by DFIs (23.0 per cent), rural CPBs (6.7 per cent), urban CPBs (2.1 per cent) and NBFCs (1.7 per cent). Therefore, the focus of discussion in this paper is mainly on the reforms for the CBs.

The banking sector reforms in 1991 aimed at liberalizing interest rates, creating a deregulated environment, strengthening the prudential norms and the supervisory system, changing the ownership pattern of banks and introducing competition in the banking industry. The reforms were first initiated for the CBs and then extended to others – DFIs, CPBs and NBFCs.

I.I. INTEREST RATE POLICY

The interest rate structure in the economy, with the objective of cross - subsidization between sectors, became increasing complex as both lending and deposit rates of the banks were prescribed by the RBI while coupon rates on government securities and

interest rates on public sector bonds, provident funds and postal saving schemes were fixed by the Central Government. To undertake reforms in the financial sector, the interest rates were liberalized in a co-coordinated way. The approach has been gradual, so that CBs are not tempted to lend at higher rates, assuming higher risk, as that would be detrimental for overall growth and development of the economy. CBs now generally charge rates of interest in accordance with their perception of creditworthiness of the borrowers and have the freedom to price their loan products based on time-varying term premia and relevant transaction costs. CBs have also been allowed to price their floating rate products by using market benchmarks in a transparent manner but floating rate products have yet to become popular. Consequently, the spreads have generally narrowed since the beginning of reforms. In order to impart greater flexibility in the interest rate structure relating to DFIs, the prescription of ceiling rates of interest on lendings by these institutions was replaced by a system of minimum rate effective from August 1991.

The Bank Rate (BR), as an instrument of monetary policy, had been dormant and unchanged from July 12, 1981 to July 3, 1991. To ensure a benchmark rate, the BR was activated by developing it as an effective signaling rate with several interest rates of significance and majority of accommodation extended by the RBI linked to it (Table - 1).

L.II. PRE-EMPTION OF BANK DEPOSITS

The banks in India were also subject to high level of prescribed reserve requirements - cash reserve ratio (CRR) and statutory liquidity ratio (SLR). CRR was initially

intended as an instrument to contain liquidity growth in an exigency, while SLR was prescribed to impose financial discipline on banks and to provide protection to depositors. Over time, SLR was increasingly being used to mobilize resources exclusively for the government. In 1991, effective preemptions on incremental deposits through the two instruments amounted to 63.5 percent (Table - 1). The public sector banks were increasingly becoming unprofitable (mainly government securities were eligible for SLR purposes and these had low coupon rates; interest was not paid on CRR balances; and 40 per cent of credit was extended to priority sector at concessional rates), with rising non-performing assets and erosion in their capital. The reforms initiated in 1991 began by lowering the reserve requirements, again gradually. CRR at present is 4.50 percent while SLR is the lowest prescribed by the RBI Act at 25.0 percent. The immediate objective, indicated by the RBI, is to lower CRR to 3 percent and to amend the RBI Act to lower the minimum prescribed SLR.

(as Table –1 about here)

The freedom to fix the interest rates helped the CBs to mobilize higher deposits, on an average annually, as per cent of GDP, from 36.5 during 1991-95 to 44.1 during 1996-04. Similarly, investment in government securities, during the same period, increased from 10.8 per cent to 15.8 per cent. However, despite the reduction in the statutory requirements, CBs continue to invest more than 35.0 per cent of their deposits in government securities as compared to the statutory requirement of 25.0 per cent since 1997 – an incident of risk aversion by CBs (Banerjee, Cole and Duflo, 2003).

I.III DIRECTED LENDING AND DEPLOYMENT OF CREDIT

In the case of directed lending, in consideration of the government's program of developing the rural sector and reducing poverty, especially since 1977, the RBI prescribed that a specific proportion of the net bank credit should go to priority sectors (gradually rose to 40.0 per cent), comprising mainly agriculture, specified small scale industry and weaker sections of the society, at concessional rates of interest. The scope for advances under priority sector lending has been enlarged, interest rates deregulated though still concessional and alternate avenues of investment have been permitted under the reforms. All new loans granted by banks to non-banking finance companies, for the purpose of on-lending to small scale industries have been reckoned under priority sector lending. Since February 2000, the RBI has regularly been advising banks to mainstream micro-finance and to enhance the outreach of micro-credit providers, in the belief that micro-finance interventions can serve as an effective tool for poverty alleviation. This program is also of benefit to the banks as it externalizes the credit delivery process and in the past has recorded high recovery rates. Morduch (1999) highlights the fact that, generally, profitability in micro-finance operations depends on the continuous availability of subsidized financial support while Singh and Srinivasan (2004) argue that directed lending reflects continuation of financial repression. However, these measures helped to reduce poverty in rural areas though it pre-empted major resources of the banks (Burgess and Pande, 2004).

Since the reforms, the share of credit extended to industry has declined while it has increased in non-traditional 'other' sectors (excludes priority sector and industry), with

the banks penetrating into retail and housing, with lending rising more than ten-fold to housing from 1995 to 2004. In the annual studies by RBI of select private limited companies (PRLC), public limited companies (PULC) and large public limited companies (LPULC), a distinct trend in bank financing is noted – (a) In the case of PRLC the share of bank finance declined from 16.0 per cent in 1995-96 to 14.1 per cent in 1999-00 and since then has been increasing to reach 15.8 per cent in 2002-03, and (b) In the case of PULC and LPULC, a steady increasing trend is witnessed with the share rising from 13.1 per cent and 11.5 per cent in 1995-96 to 16.0 per cent and 14.8 per cent, respectively, in 2002-03.² The trend in credit flow reflects the fear of banks in extending funds to the private sector and incurring non-performing assets (NPAs) while the credit to public sector is considered safe as it is implicitly guaranteed by the government (Banerjee, Cole and Duflo, 2004).

LIV PRUDENTIAL NORMS

The scaling down of the prescribed statutory ratios, and widening the scope of the priority sector lending released large amount of funds, which could be invested on the basis of commercial viability. Therefore, to strengthen the banking system, prudential norms were introduced gradually to meet the international standards. The definition of NPAs has progressively been tightened in India. Although gross NPAs have declined from 24.8 per cent in 1993-94, they are still high at 7.2 per cent in 2003-04 as compared with the international standards of about 2 per cent. Efforts have been made to deal with the stock of NPAs, by setting-up debt recovery tribunals. In 2002,

² Published annually in RBI Monthly Bulletin – last published articles are PRLC- January, 2005, pp.23-51; PULC – August 2004, pp.693-729; and LPULC – April 2004, pp.347-385.

the Parliament approved the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), which empower the CBs and DFIs to recover NPAs. The Act has already had a salutary effect in this regard and the NPAs of CBs have declined substantially; but those of DFIs and CPBs continue to be high (Table - 2).

(as Table – 2 about here)

Since 1997, action was initiated on a time-table basis to increase capital adequacy ratios, assign risk weights to government-approved securities, provide for market risk, and provide risk weights to open positions in foreign exchange and gold. Asset classification is being further strengthened and banks are being prepared for tightening of the norms for asset classification with convergence to international standards by March 2005. As a result, capital levels of the banking sector have improved markedly, with the overall capital to risk weighted assets ratio (CRAR) of CBs rising from 10.4 per cent as at end-March 1997 to 12.9 per cent as at end-March 2004, owing mainly to ploughing back of profits into reserves. The DFIs generally have a CRAR much above the stipulated 9 per cent, as at the end of March 2004.

I.V COMPETITION

To enhance efficiency in the banking sector, foreign banks and private entrepreneurs are being invited to commence banking operations in India. The entry of foreign banks was restricted earlier, but since 1991 a number of foreign banks have been allowed to operate in India. To enhance competition, foreign direct investment up to 74 per cent of ownership has been allowed in private banks and up to 20 per cent in nationalized banks. The banks have also been allowed to enter into insurance business either as joint venture participants or to take up strategic investment for providing

infrastructure and services. Consequently, the number of foreign and private banks operating in India increased from 21 and 23 in 1991 to 33 and 30, respectively, in 2004.

I.VI SUPERVISION

To ensure balanced growth of the banking sector, the supervisory function has been strengthened within RBI. A Board for Financial Supervision (BFS), set up in November 1994 under the aegis of the Reserve Bank exercises integrated supervision over the financial system. The focus of the BFS, consistent with international practice, is on off-site inspections and on control systems internal to the CBs. The BFS had set up an off-site surveillance system for CBs in 1995 to ascertain the financial condition between on-site examinations, identify institutions showing financial deterioration and act as a trigger for supervisory actions. In 1997, RBI also introduced a comprehensive regulatory framework in respect of NBFCs.³

The reforms aimed to first recapitalise the CBs and then initiate privatization. The ownership pattern of public sector banks is now beginning to change. The amendment in the State Bank of India Act, 1955 as well as the banking Companies (Acquisition and transfer of Undertakings) Acts 1970/1980, have enabled state-owned public sector banks (SOPSBs) to increasingly take recourse to capital markets to shore up their capital, subject to the maintenance of 51.0 per cent of public ownership. Of the 27 SOPSBs, 20 have raised equity capital from the market since 1996-97 and in case

³ The strategy consists of four pronged mechanism – (i) on-site inspection on the CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems) pattern; (ii) off-site

of three major CBs the share of Government/RBI has already gone down to less than 60.0 per cent.⁴ The process has been slow due to the depressed conditions in the stock market.

The market pressure on CBs to strengthen their balance sheet has increased with the need to raise capital from the capital market and hence the initiation of restructuring in operations. It is anticipated that with increasing competition amongst the banks, a number of mergers and acquisitions would occur (12 banks have amalgamated during September 1993 to August 2004 as compared with 12 amalgamations between November 1969 and August 1990) and the country will have few large national banks. The emphasis on competitiveness amongst financial institutions, development of capital markets and dismantling of administered interest rates has led to universal banking by the CBs. The DFIs are seeking to become CBs and one largest private sector DFI, has already metamorphosed into the largest private sector commercial bank – ICICI Bank. The largest state-owned DFI, Industrial Development Bank of India, is also in the process of becoming a CB soon. This healthy trend is expected to continue with the reforms. The reforms have led the CBs, especially those in the public sector, to restructure their operations in rural areas to improve profitability. A geographical analysis reveals that though the rural sector accounts for nearly half of total branches of CBs as at end of March 2003, it accounts for less than 14.0 per cent

monitoring through periodic control returns from NBFCs; (iii) effective market intelligence network; and (iv) submission of exception reports by statutory auditors of NBFCs.

⁴ These banks are Allahabad Bank, Andhra Bank, Bank of Baroda, Bank of Maharashtra, Bank of India, Canara Bank, Corporation Bank, Dena Bank, Indian Overseas Bank, Oriental Bank of Commerce, Punjab National Bank, State Bank of India, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Mysore, State Bank of Travancore, Syndicate Bank, UCO Bank, Union Bank of India and Vijaya Bank.

of deposits and 10.2 per cent of credit. Therefore, the number of branches operating in rural areas, the majority of which were opened after 1977, is declining since 1991.

The reforms have led the CBs, mainly those in public sector, to recover their health and record higher profits (Table – 3). The improvement in performance in terms of reduction in NPAs and increase in profitability of the CBs is mainly because of widening gap between lending and deposit rates in recent years and increased investment in government securities. This implies that credit to productive sectors like industry and retail market sector has been restricted. However, this trend cannot be sustained on a long-term basis, especially of investing in government securities, if the government initiates measures to minimize and then eliminate gross fiscal deficit.

(as Table – 3 about here)

SECTION II: EXTERNAL SECTOR

In view of the need to conserve limited foreign exchange reserves for essential imports (petroleum goods and food grains) and to protect domestic industry, tariff barriers on imports had traditionally been high. This restrictive trade policy led to a limited growth in external trade. In addition, capital mobility had been strictly restricted and entry of multinationals was discouraged. After 1991, the liberalization of the external sector was gradual, in consideration of the domestic and external situation.⁵ The strategy in 1991 shifted from import substitution to export promotion and the reach of export incentives was broadened to cover numerous non-traditional items. The strategy for external sector reforms had the following key elements – (a)

⁵ Gourinchas and Jeanne (2003) show that direct benefits from international financial integration may not be large for the emerging economy though indirect channels could affect the policies and governance.

sufficiency of reserves, (b) stability in the foreign exchange market, and (c) prudent external debt management. The trade policy was rationalized; export subsidies, licenses and other quantitative restrictions were abolished, the tariff structure was simplified and tariff rates were progressively reduced. The weighted average duty on all commodities declined from 72.5 per cent in 1991-92 to 24.6 per cent in 1996-97 and thereafter, it edged up again to 35.1 per cent in 2001-02 due to the imposition of various surcharges, predominantly in agriculture and consumer goods sectors.

As a result of the measures, the share of India's imports in world trade increased from 0.6 per cent in 1993 to 0.9 per cent in 2003, while that of the exports increased from 0.6 per cent to 0.8 per cent. However, India's share in global export markets is still low as compared to its share at 2.2 per cent in 1948 (Srinivasan, 2003). Trade openness (measured in terms of imports and exports to GDP) increased from 12.7 per cent in the 1980s and 18.9 per cent in the 1990s to 23.6 per cent in 2004. The importance of primary products in the export basket has declined, while petroleum products and manufactured goods, particularly engineering goods, and chemicals and related products have shown a marked increase. In the case of imports, petroleum goods continue to dominate, followed by capital goods and intermediate products.

III.1 BALANCE OF PAYMENTS AND EXTERNAL DEBT

A number of measures have been initiated since 1991 to liberalize capital inflows. Foreign investment policy also underwent a radical change to encourage foreign direct investment to India. A foreign investment promotion board was established to invite, negotiate and facilitate substantial investment by non-resident corporations

involving high technology transfer. Free repatriation of disinvestment proceeds, profits and dividends was allowed and the rate of withholding tax was aligned to international levels. The Foreign Exchange Regulations Act (1973) was amended and later replaced by the liberal Foreign Exchange Management Act (2000). Convertibility of foreign direct investment was extended to portfolio investments by foreign institutional investors in Indian stock exchanges. Indian corporations were allowed access to overseas financial markets in the form of Global/American Depository Receipts and Foreign Currency Convertible Bonds. New deposit schemes for non-residents were introduced and all those with exchange guarantees were phased out. Also, access to external commercial borrowings was made flexible.

The restrictions on current account transactions were also relaxed in a phased manner and India adopted Current Account Convertibility of the Rupee on August 20, 1994. However, India has been following a cautious approach on Capital Account Convertibility because of its criticality for a developing country (McKinnon, 1973; McKinnon and Pill, 1998; Prasad, Rogoff, Wei and Kose, 2003; and Wolf, 2004).⁶

As a result of liberalized external sector policy measures, BOP indicators have improved with the current account turning from a deficit of 3.1 per cent of GDP in 1990-91 to a surplus since 2001-02 (Table – 4). The debt indicators have also

⁶ Rodrik (1998) observes that capital account convertibility should not be thrust on every country as it may worsen the situation. Aghion, Bacchetta and Banerjee (2003), argue that economies at an intermediate level of financial development are less stable than either very developed or underdeveloped economies. These economies may become unstable with capital account liberalization.

improved since 1991, with external and short-term debt declining rapidly over the period (Table – 5).

(as Table – 4 about here)

(as Table – 5 about here)

II.II FOREIGN EXCHANGE RESERVES

India's foreign exchange reserves, as a result of measures initiated since 1991, have continued to record a healthy growth due to moderation in the trade deficit and strong capital and other inflows - a rise of US \$ 36.9 billion during 2003-2004 to \$113 billion as at end-March 2004, as compared to US \$ 21.9 billion in the previous year (Table – 6). The increase in reserves has been facilitated by Foreign Direct investment (\$129 million in 1991-92 to \$ 4.5 billion in 2003-04) and net invisibles (\$1.6 billion in 1991-92 to \$25.4 billion in 2003-04). Inward workers' remittances have increased from \$2.1 billion in 1990-91 to \$19.2 billion in 2003-04 while software exports have increased from \$0.7 billion in 1995-96 to 12.2 billion in 2003-04. The foreign exchange reserves of the country, at present, exceed 17 months of imports or about five years of debt servicing. The policy to build an adequate level of foreign exchange reserves has been based on a number of considerations - size of the current account deficit and short term liabilities, and the composition and risk profile of capital flows.

(as Table – 6 about here)

An important issue that emerges pertains to the quality of rising inflows (portfolio and foreign direct investment). India, in pursuit of its objective to accumulate reserves as well as to globalize, has been encouraging foreign participation by liberalizing the regulations for investment in various economic activities, including banking and insurance. Thus far, such investment has been permitted with minimum monitoring,

but with increasing volumes it may be necessary to adopt a cautious approach in the interest of financial sector stability (Roubini and Hemming, 2003). In India, in recent months, the use of foreign exchange reserves to finance government expenditure for infrastructure has been debated. China, which has accumulated the largest volume of reserves, has recapitalized the banks by asset swap with reserves but the foreign exchange has not been used to fund government expenditure. Though there is lack of theoretical and empirical literature on this issue, yet the expert opinion suggests a cautious approach on utilization of foreign exchange reserves to finance government expenditure (Singh, 2005a).

II.III EXCHANGE RATES

Exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilizing speculative activities, help maintain an adequate level of reserves and develop an orderly foreign exchange market, and is not governed by any predetermined target/band.⁷ Historically, India had a fixed exchange rate from 1947 till 1975 with the currency pegged to the pound sterling.⁸ From 1975 to 1991, the exchange rate of the rupee was adjusted regularly on the basis of the weighted average of the exchange rate movements of the currencies of the major trading partners of India, with pound sterling as the intervention currency. Despite these regular adjustments, the exchange rate was overvalued and resulted in erosion of international

⁷ The reason being that in the very short-run, expectations about the likely behavior of a currency can play a major role in determining the rate and given the bandwagon effect, expectations can become self-fulfilling, especially in thin markets. The day-to-day movement in currency markets is further complicated by volatility in private capital flows, which are sensitive to short term developments.

⁸ During this period, major revisions in the exchange rate were made in June 1966, July 1972 and July 1975. In view of the instability in the exchange rate of the pound sterling during the early 1970s, the

competitiveness by 1990-91.⁹ Therefore, it was adjusted downward in two stages on July 01 and 03, 1991 to effect about 18 percent reduction in the external value of the rupee (Table – 7). The exchange rate regime, soon thereafter transited from a basket-linked managed float to a market-based system in March 1993, after a short experiment with a dual exchange rate between March 1992 and February 1993. The exchange rate of the Rupee (end-year), as compared with US\$ has depreciated annually, on average, by 2.9 per cent for the period 1992-04, while depreciation against other major currencies, on average over the same period, has been higher – Pound (3.6 per cent), Euro (11.0 per cent) and Yen (5.7 per cent). In the last two years, the Rupee has appreciated by 5.6 per cent annually against the US\$ while recording sharp depreciation against Pound (7.1 per cent), Euro (12.1 per cent) and Yen (6.8 per cent).

(as Table – 7 about here)

SECTION III: FINANCIAL MARKETS

The development and regulation of money, government securities and foreign exchange markets is the responsibility of the Reserve Bank that emerges out of its role as monetary authority and debt manager for the Government and its interest in maintaining stability of the financial system. The emphasis has been on removal of structural rigidities, encouragement of wider participation, introduction of new instruments and development of legal, regulatory, institutional and technological infrastructure for orderly market activity.

Indian rupee was delinked from the pound sterling with effect from September 25, 1975 and its value began to be determined with reference to a basket of currencies.

⁹ The exchange rate of the rupee as measured by the real effective exchange rate (REER) appreciated by about 2 percent as a result of widening inflation differentials between India and major industrial

III.I MONEY MARKET

To facilitate the operation of monetary policy the efficiency of the transmission mechanism has to improve. Therefore, RBI initiated measures to develop the money market. The reforms included introduction of new instruments (different maturities of Treasury bills, commercial paper, certificates of deposits and inter-bank participation certificates) and development of dealers (primary and secondary).

In the call money market, major reforms were undertaken from 1991 onwards, though some measures had been initiated in 1987. To develop the call market, non-bank participants were allowed to operate and inter-bank liabilities were freed from reserve requirements to facilitate emergence of a smooth yield curve and reduce volatility in the call rates. The objective of making the call market a purely inter-bank market has been pursued since 2001 as other markets and instruments for non-bank participants have developed. To regulate short-term liquidity in the system, the RBI introduced Repurchase Agreements (Repo) on December 10, 1992 and a Liquidity Adjustment Facility (LAF) on June 5, 2000 under which it absorbs (repo) or injects liquidity (reverse repo) in the system on a daily basis. The repo rate has become an important signaling instrument for the financial markets, along with the CRR and the BR. The operations of LAF have been successful in reducing the volatility in the call rate (Graph - 1).

(as Graph – 1 about here)

countries despite continuing depreciation in the nominal effective exchange rate (NEER) by 2.4 percent during October 1990 - March 1991.

The development of the money market has led to the emergence of an interest rate structure that is market related (Table - 8) and a narrowing of the spreads between different segments of the Treasury bills market (Graph-2). In the secondary market, the share of repo has generally been low as compared to outright transactions. Since 1997-98, 364 day Treasury bills have accounted for more than three-fourth of total transactions in Repo and more than half in the outright market, generally reflecting the trend in the amount of bills outstanding. Turnover ratio was marginally higher (ratio of turnover to outstanding bills at end of year) for 364-day Treasury bills in the Repo market and substantially higher for 91-day bills in the outright market (Singh, 2005b).

(as Table – 8 about here)

(as Graph – 2 about here)

III.II GOVERNMENT SECURITIES MARKET

The fiscal policy compulsions rendered internal debt management policy passive before 1991. The RBI, as a debt manager, had little control on some of the essential features of debt management like the volume, maturity, term structure or the yield curve but had to support the floatation in terms of initial subscription. In the 1980s, the volume of long-term debt expanded rapidly (Singh, 2005b). The maturity of market loans remained highly skewed at the longer end, with the weighted average maturity of 16.1 years of outstanding loans in 1991. Total amount of debt securities increased from Rs.185.4 billion (or 12.9 per cent of GDP) at end-March 1981 to Rs.861.4 billion (15.2 per cent) at end-March 1991 and to Rs.8,811.5 billion (31.8 per

cent) at end-March 2004. Government outstanding debt accounted for 78.9 per cent of the total outstanding debt in the market as at end of March 2004.

To develop the government securities market, an active internal debt management policy was pursued from 1992. To offer market-related yields to suit investor expectations, 5-year and 10-year dated securities were auctioned, for the first time, on June 3 and August 3, 1992 respectively. Since then the auction system has increasingly been used and new instruments have regularly been introduced, including zero coupon bonds, floating rate bonds and capital indexed bonds. The maturity profile of government bonds underwent a change and the maximum maturity between 1991 and 1992, was reduced from 20 years to 10 years. On improvement in the market conditions and in consideration of the absorptive capacity of the market, the maximum maturity of Central government securities was extended to 20 years in 1997-98, 25 years in 2001-02, and finally to 30 years in 2002-03, while that for the State government loans continues at 10 years. The State Governments continue to raise resources from the market through a traditional (non-auction) method but the coupon on these securities is fixed slightly higher (25 to 50 basis points) than the Central Government bond of similar maturity - an illiquidity premium (due to lower volumes of outstandings and therefore low tradability). Since January 1999, even some states have begun to raise a partial amount of their allocated market borrowings through auctions. The coupon rates on government securities rose in the initial years of reforms but have been declining since 1996, partly ascribed to efficiency in financial markets (Table - 9).

(as Table – 9 about here)

In view of the dormant government securities market till 1992, the RBI could not use open market operations (OMO) as an instrument of monetary policy. The reforms in the government securities market have now facilitated active use of OMO as a tool of market intervention through auctions. The market-related rates, both in the primary auction as well as the OMO, have also helped to achieve diversification of the investor base, with the share of non-captive investors increasing, though statutorily, CBs, insurance companies and provident funds continue to invest in government securities (Singh, 2005b).

To develop the secondary market, primary and satellite dealerships were established in 1995 and 1996, respectively, and in January 2003, trading of Government securities on the stock exchange was also initiated. A highly liquid and vibrant secondary market requires a transparent system of trading and a secure system of payment and settlement. A negotiated dealing system (NDS) operationalized from February 15, 2002, provides on-line electronic bidding in primary/OMO/ LAF auctions, screen-based electronic dealing and reporting of transactions in money market instruments, secondary market transactions in government securities, and dissemination of information on trades in real time. NDS facilitates paperless settlement of the transactions in government securities with connectivity to the Clearing Corporation of India Ltd (established in April 2001 and operational since February 15, 2002) and the Delivery Versus Payment settlement system at the Public Debt Office. The Real Time Gross Settlement system has been operational since March 2004.

In the secondary market for dated securities, Central government securities dominate trading while the share of state government paper is marginal (0.5 to 1.0 per cent) (Singh, 2005b). Turnover ratio (turnover to outstanding at end of year) though rising recently is still very low for both outright sale at 2.2 and Repo at 1.3. The reforms have led to the emergence of a yield curve that is market-related and is increasingly used as a benchmark for other instruments in the debt market. The spreads between different segments of the government securities market are narrowing in the recent years (Graph -3) though not as much as in developed markets like the US.

(as Graph – 3 about here)

The interest rate is significantly influenced by the measures taken by the RBI and the prevalent market conditions. The different financial markets have begun to integrate since the onset of reforms (Jena, 2004), with the coupon rates on government securities aligning with other rates in the market (Table - 10).

(as Table – 10 about here)

III.III FOREIGN EXCHANGE MARKET

The foreign exchange market in India originated in 1978 when CBs were allowed to undertake intra-day trading in foreign exchange but was dormant till 1993. Since 1993, several measures have been introduced progressively to widen and deepen the foreign exchange market. First, CBs have been given freedom to fix their overnight position/gap limits, initiate trading positions in the overseas markets, determine the interest rate on NRI deposits and use derivative products for asset-liability management. Secondly, to facilitate integration of domestic and overseas money markets, Authorized Dealers (ADs, mainly CBs) have been allowed to borrow abroad

within prudent limits. Finally, corporates have been given freedom to manage their foreign exchange exposures.

The foreign exchange market continues to be thin, localized, and expectations-driven and exhibits 'herding' behavior. The average daily turnover increased to US\$ 6.3 billion in 2003 from US\$ 5.2 billion in 1998. The medium-term endeavor is to develop the foreign exchange market in terms of depth and liquidity, introduce new instruments and pricing strategies, and encourage greater integration with other segments of the financial market. As a result of the reforms and the policy to restrict volatility through intervention if necessary, the exchange rate has been reasonably stable (Table - 11). RBI intervention, however, is small in terms of volume – less than 3.0 per cent of turnover in 2002-03, a year argued to be of high intervention, which demonstrates the predominant role of market forces in determination of the external value of the rupee (Mohan, 2004).

(as Table – 11 about here)

III.IV CAPITAL MARKETS

In terms of financial sector reforms, it was considered necessary for investor confidence that capital markets should be encouraged to grow under the supervision of a strong regulatory framework. Therefore, in January 1992, the Securities and Exchange Board of India (SEBI), was accorded statutory status as an autonomous body to protect investors' interest and to promote the development of the capital market. In the primary market, all government controls relating to pricing of equity issues and their timing have been removed since then. Interest rate restrictions on debentures and bonds issued by public sector enterprises, was rescinded in August

1991. In the secondary market, the traditional open outcry system has been replaced with a transparent, screen-based computerized trading system, which can be accessed by trading members (9,368 as at end of March 2004) across India (357 cities as at end of March 2004) to meet the requirements of nearly 21 million investors (during 2000-01, according to a Survey conducted by SEBI in 2001), mainly located in urban areas. The process of dematerialization of physical securities is completed. To reduce risks in the market and protect the interest of investors, in line with international best practices, rolling settlement on T+2 basis is in use since April 1, 2003 . The clearing and settlement system is being emphasized by SEBI and many stock exchanges in India are setting it up now. The disclosure standards are being strengthened to protect the interests of the investors. The number of stock exchanges increased from 11 in 1990 to 23 in 2003 while listed companies on the stock exchanges has increased from 6,229 in 1990-91 to 9,413 in 2002-03. In March 2001, the government proposed that all the 23 stock exchanges that are owned and managed by the brokers would be corporatised whereby ownership, management and trading membership would be segregated. Consequently, the boards of some stock exchanges in India have been revamped and broadened so that they represent diversified interests.

Consequent to the reforms, resource mobilization in the primary market increased from 2.5 per cent of GDP in 1990-91 to 3.8 percent in 2000-01, but since then the markets have been depressed for multiple reasons – high real interest rates, poor performance of mutual funds, lack of confidence of the investors due to high incidence of vanishing companies and consequently stringent conditions imposed by

the regulator on public issues (Table – 12). In the primary market, corporates prefer the private placement route, which has accounted for more than four-fifth of total resources mobilized since 1997. Since then, the share of debt issuance has also been more than nine-tenth of total resources raised from the market. The corporate bond market, accounting for less than a quarter of the primary market and less than one-tenth of the secondary market, is under-developed, and marked by a low investor base and an absence of variety in instruments. The share of finance raised from the market in total external finance of the corporate entities increased from 19.2 per cent in 1990-91 to 53.2 per cent in 1993-94 but since then has declined due to the adverse market conditions.

(as Table – 12 about here)

In the secondary market, reforms have led to increased activity except for some period during March 2000 to May 2003 because of domestic reasons (border tension, uncertainty in dis-investment plan of the Central Government, slowdown in industrial production and bad monsoons) and international reasons (tension in Middle east and rise in international oil prices). Market capitalization increased from Rs.4,000 billion in 1993-94 to reach a peak at Rs.11,926 billion in 1999-00 and after declining for three years increased to Rs.12,105 billion in 2003-04 while the turnover increased from Rs.2,037 billion in 1993-94 to peak at Rs.28,810 billion in 2000-01 and since has been low (Table - 13).

(as Table – 13 about here)

III.V CONSENSUS BUILDING OF REFORMS

Rodrik and Subramanian (2004) correctly isolate attitudinal shift since 1991 as an important factor in the reforms process in India. The pledging of gold to the Bank of

England in June 1991 was a sensitive issue and the opportunity that the situation offered helped in initiating reforms - even those that were un-acceptable till then - but to sustain the process, a consensual effort was required. Therefore an institutionalized framework was established to involve all the stakeholders in the formulation of policy and its implementation in the financial sector. Several specialized groups were constituted that continue to ensure consensus building for reforms. In the Government securities market, the Cash and Debt Management Group consisting of officials from the Government of India and the RBI deliberate and advise on the borrowing program of the Government. In view of the ever changing market conditions, officials of the Central and State Governments, the Planning Commission and the RBI meet twice a year to discuss the finances of the State Governments, with special reference to cash and debt management. In the context of growing integration of the financial markets, a Technical Advisory Committee, comprising academicians, professionals and financial market participants, meets regularly to review the developments in the foreign exchange, money and government securities markets, and make suitable recommendations. Self-regulatory bodies, operational since 1997, in these markets have been playing an important role in their development and providing regular feedback to the regulator.

SECTION-IV: CONSEQUENCES OF REFORMS

In view of the on-going multi-sector reforms being undertaken in India, especially the financial sector, the structure of the economy has undergone a significant change. The sectoral composition of national income has changed with services accounting for

56.2 per cent of GDP in 2003-04 as compared to 46.1 per cent in 1990-91. The share of banking and insurance in the services sector has increased from 7.5 per cent during 1981-85 to 11.8 per cent during 1993-99. The finance ratio, as the ratio of total financial claims to national income, increased from 0.3 during 1981-85 to 0.5 in 1995-96, according to the latest data available.

The economic indicators of the economy after the initiation of reforms reflect a positive impact with an average annual growth rate of GDP rising to 6.1 per cent in the recent years (Table- 14). The economy, during this period, has successfully been able to cushion four years of negative growth in agriculture, high oil prices and tension in Middle-East (affecting remittances), a shift in export destinations with the collapse of Soviet Union, and recessionary global goods and capital markets. The interest rates are now market determined and its impact is noted on domestic savings and investment. The savings by the household (in the financial assets - bank deposits, mutual funds) and private sector has increased as has capital formation. The performance of the public sector has been dismal though – savings have been negative since 1998-99 and the share of investment has been declining since 1992-93. The economy is increasingly getting monetized and inflation has consistently been low.

(As Table – 14 about here)

An important question that arises here is whether the shift to higher growth rates occurred in 1980s (Rodrik and Subramanian, 2004) or did it emanate from the reform process. The data does indicate that the shift to higher growth rates did occur in 1980s but the comparison with the shift since 1991 may be inappropriate. In fact, there is a

political economy aspect that ushers a structural break in the long-term trend - financial emergency from June 1975 to March 1977 when capacity utilization in industry and services improved substantially. India had its first non-Congress government in March 1977, representing a multi-party coalition. The gandhian principles of development of rural sector, emphasis on *Swadesi* (domestically produced goods), development of village, cottage and small-scale industry, and decentralization of power, as against expansion of public sector enterprises and capital-intensive large industries, were emphasized by the new regime. The co-operative movement in rural sector gained momentum, rural co-operative banks were re-organized and commercial banks were required to extend credit to the rural sector on priority basis. In January 1980, though Congress returned to power, the gandhian policy measures were continued and in addition, capital market, industrial and import policies were liberalized. In December 1989, once again India had a non-Congress multi-party coalition government. The emphasis generally continued on public sector, protection of domestic industry, import substitution and export promotion. The growth rates recorded by the economy were high during the 1980s, especially in industry and services but constrained by limitations of infrastructure, especially power, uneven built-up of capacity in industry still controlled by licenses and permits, directed lending, high fiscal and current account deficits, and strongly regimented exchange controls. The unsustainability of such selective liberalization became apparent in the foreign exchange crises of June 1991.

Consequent to reforms, the profitability of the CBs in India is now comparable with those in the developed countries. The non-performing loans of the banks in India though high compared to the developed countries have rapidly declined to 7.2 per cent in March 2004. The profitability of major banks in India has improved and is comparable with international standards with pre-tax profits having increased to 1.0 per cent and operating costs having declined to 2.2 per cent in 2002-03. The capital markets in India have also been developing. India has been ranked seventeenth by Standard and Poor's in terms of market capitalization, sixteenth in terms of turnover and second in terms of listed companies on stock exchanges after the USA.¹⁰

The reforms have helped to develop and integrate the financial markets. The economy benefited from these reforms and therefore could withstand some of the shocks that impacted it recently, and still pre-pay some of its high cost external debt and undertake domestic debt restructuring.

IV.I SOUTH EAST ASIAN CRISES

India was not insulated from the South East Asian crises of 1997. The Reserve Bank of India responded to the crisis, when the pressure on rupee in November/December 1997 was noted, by altering the course of easing of monetary policy as per the measures announced earlier in April 1997. As demand for US\$ exceeded supply, one month forward premia (which in India reflects demand-supply pressure and not necessarily interest rate differentials) rose from 4.3 per cent on October 14, 1997 to

¹⁰ The number of listed companies reported by Standard and Poor's is lower than that reported by SEBI (refer Table - 13).

10.4 per cent on December 16, 1997. The exchange rate of the Rupee per US\$ depreciated from Rs.36.2 to Rs.39.4 over the similar period. The liabilities of the RBI in terms of net forward market commitments rose from US\$ 944 million as at end of September 1997 to US\$ 1,956 million as at end of December 1997. In order to reduce volatility, curb speculative activity and ward off any threat of contagion, several monetary measures, including raising of CRR and restricting forward contracts, were promptly taken in December 1997. As these proved ineffective and the one month forward premium after a dip to 7.9 per cent (exchange rate at Rs.39.3) on December 31, 1997 continued to rise to 23.8 per cent (exchange rate at Rs.40.4) on January 15, 1998, another package of monetary measures was announced on January 16, 1998. These measures included - (i) raising of the BR by 200 basis point, (ii) raising of CRR by 50 basis points, (iii) reduction of general refinance limits to CBs from the RBI, and (iv) raising the cost of money for the importers. These measures finally succeeded in restoring normalcy in the markets with the exchange rate appreciating to Rs.38.7 on January 21, 1998 though the forward premium was stubborn and returned to 3.3 per cent by April 13, 1998.

The RBI also resorted to continued use of 3-4 day Repos to manage short-term liquidity in the system during this period. Repo auctions with cut-off rate varying between 2.9 and 5.0 per cent were conducted up to December 3, 1997. The repo rates were sharply raised to 6.5 per cent on December 4, 7.0 per cent on December 11 and further to 9.0 per cent on January 17, 1998.

IV.II THE PERIOD AFTER SEPTEMBER 11, 2001

The position in the call money market was tight following the events of September 11, 2001 and was accompanied by pressures in foreign exchange and gilt segments as financial markets in the US were affected for more than a week as also across the world. In India too, the markets were beginning to show signs of nervousness immediately after the attack. The one-month forward premium rose from 4.3 per cent (exchange rate Rs.47.4 per US\$) on September 12, 2001 to 7.5 per cent (Rs.48.2) on September 17, 2004. The announcement of opening of a purchase window for select Government securities by RBI, on an auction basis, on September 18, 2001 and sale of foreign exchange by RBI restored market sentiment – the forward premium declined to 6.0 per cent immediately on the same day while the exchange rate recovered to Rs.47.9 on September 19, 2001. The Reserve Bank continued to conduct regular auctions for open market purchases aggregating Rs.50 billion during September 18 - October 10, 2001 to support the gilt market in the face of the steep fall in the government security prices due to adverse external developments.

IV.III FOREIGN EXCHANGE INFLOWS AND STERILISATION

In recent years, India has experienced a significant spurt in foreign exchange inflows, with the foreign exchange reserves rising to US \$113 billion by end March, 2004. The Foreign Currency Assets of the Reserve Bank rose by US \$ 20.8 billion (Rs.924 billion) during 2002-03 and US \$ 35.6 billion (Rs.1,247 billion) during 2003-04. The liquidity impact of large inflows was managed mainly through the daily LAF. Liquidity absorption through LAF on a daily average basis, amounted to Rs.112 billion during 2002-03 and around Rs.300 billion during 2003-04. The LAF

operations were supplemented by sales through OMO amounting to Rs.537 billion during 2002-03 and Rs.418 billion during 2003-04. To stabilize the market and to continue to undertake the sterilization measures, the Market Stabilization Scheme (MSS) was introduced in April 2004. The overall ceiling of Rs. 800 billion is stipulated for 2004-05 under MSS and the paper already issued by November 13, 2004 amounted to Rs.557 billion. The high foreign exchange reserves have also been used to pre-pay some of the high cost external debt. In February 2003 and then during 2004, the Government pre-paid a part of its high cost external debt amounting to US \$ 5.63 billion to the Asian Development Bank and the World Bank. Similarly, high cost bilateral loans (especially Canada and Netherlands) amounting to US\$1.1 billion have also been pre-paid. The possibility of further prepayments of external debt are being explored.

IV.IV DEBT RESTRUCTURING

Debt restructuring which was sought as a part of fiscal consolidation included - (i) pre-payment of external debt (explained earlier), (ii) buy-back of government securities by the Central Government from the CBs and DFIs, and (iii) restructuring of State Governments' debt to the Centre through a debt swap scheme. The scheme of debt buy-back, first ever in India, was implemented on July 19, 2003. The Government of India bought back high cost, illiquid securities by paying a premium. In lieu of these illiquid securities, four liquid securities were issued. The buy-back was conducted for CBs and select DFIs, and the CBs were allowed additional income-tax deductions to the extent such business income was used for provisioning of their

NPAs. The repurchase of securities was through a live interactive electronic platform where bids could be revised while the reissue of fresh securities in lieu of auctioned securities was at a pre-announced fixed price notified a day in advance. In the auction process, the offer price for each security emerged, and the difference between the market value and face value was shared between the government and market participants. Under the mutually agreed debt-swap scheme between the Central and the State Governments, all State loans from the Centre bearing coupons in excess of 13.0 per cent are to be swapped with market borrowings and small savings proceeds at prevailing interest rates over a period of three years ending in March 2005. The scheme has been successful as the States have been able to raise resources from the market at interest rates, which are nearly half the rate at which the original loan was incurred and as a consequence, are expected to save a substantial amount of interest payments in future.

SECTION – V: CONCLUSIONS AND LOOKING AHEAD

The sequencing of reforms was very critical. The economy could undertake structural reforms (removing rigidities) when it stabilized (fiscal and current account deficits) but given the situation in 1991 it could only be stabilized if structural adjustment was initiated. Therefore, the reforms in the real, fiscal, external and financial sectors had to be simultaneously implemented. The reforms in the financial sector were required to be supportive to the other sectors and hence very gradual. The prescribed statutory ratios for the banks were lowered in a phased manner considering the development of the money and government securities market, and the deficit of the government.

The reforms are an on-going process with many measures that were initiated in 1991 being incomplete while others have begun to show encouraging results. The financial markets have developed, regulatory and supervisory institutions have been established, and the general attitude towards reforms has also changed. The pace of reforms in the real sector, including the issue of disinvestments and pricing of public utilities, and those pertaining to labor regulations and compensation, including pensions and provident funds, have been rather slow, as they are difficult to implement.

Reforms in the fiscal policy have been slow to yield results. The persistence in the fiscal deficit and the rise in domestic debt relative to GDP is a concern, despite the attempted fiscal correction. On the issue of returns on investment in public sector enterprises, it can however be suggested, that innovative schemes where assets are not sold but services emerging from those assets are privatized, may have to be considered. Illustratively, these measures could include contracting out such services as - (a) metering, billing and collection of power and water charges; (b) catering, sanitary and security services in railways; and (c) collection, sorting and distribution of postal mail in selective areas. These selective measures could help to improve competitiveness in the public sector, increase the availability of services and thereby enhance the welfare of the people.

The administered interest rate regime has been dismantled, facilitating development of the financial markets and more broad-based ownership of government securities. With the elimination of automatic monetization in 1997, the Central and State

Governments are provided financial resources for a short-term by the RBI at BR, while long-term financial resources are being raised at market related rates of interest directly from the market. The money and government securities markets have developed substantially and it is anticipated that RBI will cease to operate in the primary market by 2006, though it will continue to conduct open market operations. Therefore, with the increasing development of the markets and their absorptive capacity, the issue of separating debt from monetary management can now be considered - a step that would provide independence to the RBI to pursue the goal of price stability.

RBI regulates and supervises the financial system. Since 1998, focused development in this sphere has taken place especially in codifying the international practices and assessing the domestic standards. In the banking sector, especially the commercial banks, measures on prudential norms, income recognition, asset classification, provisioning, supervision and regulation are beginning to meet international standards. The CBs now need to acquire professional skills to identify users, assess risk and extend credit to the private sector and not continue to invest in government securities and guaranteed bonds beyond the statutory stipulations. The CBs have begun to restructure their operations in view of the need to strengthen their balance sheets to raise capital from the market. It is anticipated that with increasing competition amongst the banks, a number of mergers and acquisitions would occur and the country will have few large national banks. The restructuring of operations of CBs in the rural sector can also be expected to continue. The rural sector can be

serviced mainly by the CPBs, which already have more than 113,000 branches and are being strengthened by the Government, and also by NBFCs. In addition, the role of micro-credit also needs to be analyzed in the context of the existing scheme of priority sector lending, and the network of CPBs and NBFCs in rural areas.

Since 1991, external sector management, has helped to build foreign exchange reserves through non-debt creating flows, to restrict short term debt and to maintain an acceptable level of current account deficits. The main contributors are foreign investment, workers' remittances and software exports reflecting increasing global integration. Though the capital flow to India is small compared to some other developing countries but the quality of flows needs to be monitored in the interest of financial sector stability. In addition, the proposed initiative of utilizing reserves to finance government expenditure needs to be cautiously examined to avoid an inflationary spiral and misutilisation of resources.

India was successful in avoiding the impact of the South East Asian Crises and in pre-paying some of its external debt and restructuring its internal debt in recent years. The lessons that emerged from the experiences of 1997-98 and September 2001 show that monetary policy has to be continuously alert to market developments both at home and abroad, and appropriate corrective measures have to be taken promptly. Prompt action could cause some interruption of pre-determined reforms, but that constant monitoring and timely action helps to prevent self-fulfilling speculative activities.

India continues to maintain steady growth since the initiation of the multi-sector reforms undertaken since 1991. Therefore, the crucial issue is whether the financial sector reforms have raised India's growth rate? The evidence presented in this paper strengthens the belief that carefully designed and diligently sequenced reforms since 1991 have led the economy to consistently record high growth rates, despite various domestic and external shocks. Thus, the evidence seems to add to the growing body of empirical literature, which indicates that development of the financial sector facilitates economic growth.

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