BUSINESS STANDARD

Fixing Financial System Key to High Growth

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India has come a long way since it embarked upon its journey of economic reforms more than two decades ago. With a projected gross domestic product or GDP growth of over 7 per cent, it is now one of the fastest-growing major economies in the world. The high growth rate has been supported by a growing financial sector, in addition to continued efforts by the Narendra Modi government to push forward with structural reforms. However, the recent rise in financial sector vulnerabilities has added a dose of anxiety to an otherwise sunny outlook for India's growth prospects.

As the National Democratic Alliance or NDA government gears up to present the Union Budget for the next fiscal year in less than a week, it is the right time to take stock of progress made on the reform agenda and identify gaps that need to be filled.

To sustain India's high growth rate and spread its benefits more evenly, the financial sector has a crucial role to play in mobilising resources and channelling them to productive uses.

India's efforts to push through financial sector reforms in the last two years have been promising. Some of the important accomplishments include the introduction of an inflation-targeting regime, easing of norms to apply for banking licences, introduction of an Insolvency and Bankruptcy Code (IBC), and the launch of the Pradhan Mantri Jan Dhan Yojna, to name a few. However, India has a long, unfinished reform agenda that it needs to pursue with utmost urgency to sustain the high growth rate in the long term.

The most pressing issue facing the Indian financial sector is the rising stock of non-performing assets or NPAs in the banking system. Bank credit is an important source of finance for households and firms in India. The rising stock of NPAs, which amounts to over Rs 7 trillion, has been eroding banks' profits and inhibiting their ability to provide credit. Even though non-food bank credit growth has recovered, growth of bank credit to the industrial sector remains subdued. Within the industrial sector, credit to medium enterprises continues to decline, while growth in credit to large enterprises is barely positive. Robust credit growth to the industrial sector is essential to support capital formation and economic activity. It will be difficult for the banking system to support high growth, especially in the industrial sector, if the growth in NPAs is not checked.

It is certainly promising that the government seems to recognise the urgency for broad-ranging banking reforms, but effective implementation and a multi-pronged approach are essential. Recapitalisation of public sector banks (PSBs) is important, but should be done in tandem with governance reforms that make these banks more accountable and change their incentive structures to promote efficient allocation of credit to the most productive uses. More

competition through entry of new banks and greater private ownership of PSBs would increase the overall dynamism of the banking sector.

At the same time, it is important to develop corporate bond markets, which can provide an alternative source of funding to firms. As we argue in our recent Brookings Institution report, quantitative restrictions on institutional investors should be removed to broaden the investor base. There is also a need to develop secondary markets which will allow market participants to hedge risks arising from their investment in corporate bonds.

The current issues with each segment of the Indian financial sector may seem disparate but are in fact interconnected. For instance, the statutory liquidity ratio (SLR) for banks is 19.5 per cent of their net demand and time liabilities. Such a high SLR implies that banks have little room in their portfolio to invest in assets other than government securities. A high SLR, in addition to quantitative restrictions on institutional investors to invest in corporate bonds, translates into weak demand for corporate bonds. As the corporate bond market remains underdeveloped, corporates are left with few avenues to raise debt. They end up turning to the banking sector, thereby exposing the banking sector to concentration and credit risk. In the absence of a robust bankruptcy framework, banks have to bear the burden of losses emanating from failed projects, largely reflected in rising NPAs, further inhibiting their capacity to lend.

Hence, what is needed is an integrated approach to financial sector reforms that takes into account the nexus between different sectors rather than thinking about reforms in each sector separately. The underlying institutional framework needs to be strengthened to support primary and secondary capital markets. This would require effective implementation of the IBC, creation of a resolution mechanism for failing financial institutions, and consolidation of regulation across closely connected markets. It would be helpful to lay out a clear medium-term path for bringing down the SLR, a process that the Reserve Bank of India or RBI has already initiated, in order to deepen bond markets and reduce financial system distortions resulting from financing of fiscal deficits.

In addition to fixing financial markets as we have described above, it is equally important to sustain momentum on increasing financial inclusion, improving financial literacy, and strengthening consumer protection.

India has enormous growth potential. To unlock this potential and to maintain an upward growth trajectory, it is crucial that the government pursue financial market development and reforms. It is clear what needs to be done — what is needed now is a strong political will to push through the unfinished reform agenda aggressively and rapidly.

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