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**FINANCIAL SECTOR DEVELOPMENT AND ECONOMIC GROWTH IN INDIA**

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**ABSTRACT**

This paper examines the impact of the developments in the financial sector on economic growth in India in the post-reform period. The paper extends the models of Pagano (1993) and Murinde (1996) to formalize the relationship between financial development and economic growth in the structure of an endogenous growth model. The model is then estimated using quarterly data for the period 1993 to 2005 for India. India's financial system comprising its banks, equity markets, bond markets, and myriad other financial institutions is a crucial determinant of the country's economic growth trajectory. Financial sector reforms in India introduced as a part of the structural adjustment and economic reforms programme in the early 1990s have had a profound impact on the functioning of the financial institutions, especially banks. The principal objective of financial sector reforms was to improve the allocative efficiency of resources, ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. The paper is presenting financial sector reforms in India, identify the emerging issues and explore the prospects for further reform. The first part is devoted to a brief background financial sector reforms.

**Key words :** sharply, economics, pro-capitalism.

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**INTRODUCTION**

The financial system's ability to channel domestic savings and foreign capital into productive investment and to provide financial services such as payments, savings, insurance, and pensions to a vast majority of households will influence economic as well as social stability. However, the system is not providing adequate services to the majority of domestic retail customers, small and medium-sized enterprises, or large corporations with the government ownership of 70 percent of the banking system and hindrances to the development of corporate debt and derivatives market have affected the financial development. Obviously this will become a barrier to high growth. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. With a view to making the reform measures mutually reinforcing, the reform process was carried forward through analysis and recommendations by various Committees/Working Groups and extensive consultations with experts and market participants. The financial sector is properly regulated but unleashed from the Government strictures that have suppressed the development of certain capital markets and kept others from becoming competitive and efficient otherwise it has the potential to generate millions of much needed jobs and, more important, have an enormous multiplier effect on economic growth. At times, financial stability is more important than ever to keep growth from being derailed by epoch hitting the system, especially from abroad. Although the Indian economy dodged the Asian crisis and the recent sub prime crisis, a lot remains to be done to secure the stability and durability of the financial system.

**INDIA'S PRE-REFORM PERIOD AND FINANCIAL REFORM:**

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of

10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India's financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources to strategically important sectors.

Reflecting these views, all large private banks were nationalized in two stages: the first in 1969 and the second in 1980. Subsequently, quantitative loan targets were imposed on these banks to expand their networks in rural areas and they were directed to extend credit to priority sectors. These nationalized banks were then increasingly used to finance fiscal deficits. Although non-nationalized private banks and foreign banks were allowed to coexist with public-sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible.

In the period 1969-1991, the number of banks increased slightly, but savings were successfully mobilized in part because relatively low inflation kept negative real interest rates at a mild level and in part because the number of branches was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound owing to their poor lending strategy and lack of internal risk management under government ownership. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15 per cent, while capital and reserves averaged about 1.5 per cent of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks' true performance. Further, in 1992/93, non-performing assets (NPAs) of 27 public-sector banks amounted to 24 per cent of total credit, only 15 public-sector banks achieved a net profit, and half of the public-sector banks faced negative net worth.

### **RBI AND GOVERNMENT:**

During the early 1960s, Governor Iengar identified four areas of potential conflict between the Bank and the central government. These were interest rate policy, deficit financing, cooperative credit policies and management of sub-standard banks. It may be of interest to note that these four areas are still some of RBI's concerns. At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the RBI also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations.

In fact, during the recent period, the RBI enjoys considerable instrument independence for attaining monetary policy objectives. Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the RBI have enhanced its credibility and instrument independence. It has been pointed out by some experts that the RBI, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period.

### **REFORMS IN INSURANCE SECTOR:**

The insurance sector, in many respects, was most in need of reforms in 1991, being completely nationalized at the time. The public-sector Life Insurance Corporation had a complete monopoly on life insurance and pension products while the General Insurance Corporation, operating through four subsidiaries, monopolized general insurance. The government not only owned the insurance companies, it also performed the role of regulator. As it happened, the pace of change in this area was much more gradualist than elsewhere.

The need to open the sector to private competition as part of the broader thrust of financial sector reforms was recognized relatively early and the Congress government that initiated the reforms appointed the Malhotra Committee in 1993 to recommend a future course of action. The committee submitted its report in January 1994 recommending the establishment of an independent regulatory authority for insurance and opening up the sector for competition from new private entrants. Although the Finance Ministry in pursuit of these recommendations did some preparatory work, decisions were postponed because of the impending general elections in 2014.

### RESULT & DISCUSSION:

The basic objective of opening up was to tap the tremendous potential of the insurance sector in terms of increase in the number of insurance products in addition to players. It was aimed at throwing open more options for consumers in terms of products, price benefits and procedures. It was also aimed at generating long-term funds for giving a real push to the infrastructure sector. While fulfilling the objectives for which the sector was opened up, post-liberalization insurance sector joined the stream of service industry which experienced a boom in its growth. In a matter of nine years, the industry has brought about paradigm shift in the meaning and relevance of 'Insurance' to the common man.

**Table-1**

**Deposit Insurance and Credit Guarantee Corporation - Liabilities and Assets**

(Rupees crore)

Year	Surplus Balance	Investment Reserves	Total Liabilities Assets	Investments in Central Government Securities (at Cost)
2005-06	271	76	787	678
2006-07	3205	261	5749	4874
2007-08	3687	261	6600	5453
2008-09	4683	261	7584	5999
2009-10	5037	259	8740	7079
2010-11	6942	475	11797	9363
2011-12	8077	641	14102	10284
2012-13	9767	954	17008	12194
2013-14	11809	1050	20853	14399
2014-15	14339	929	25515	17268
2015-16	16877	1661	29682	21532

This growth process in the sector has pioneered abundant opportunities in terms of employee generation both within the sector and in supporting services sector like Business Process Outsourcing (BPO) and Information Technology (IT). The growth is expected to be sustained in the coming years with dynamic changes in the insurance sector in terms of product innovation,

This growth process in the sector has pioneered abundant opportunities in terms of employee generation. In this scenario, Chartered Accountants (CAs) are thrust with responsibility to authenticate various information submitted to the Regulator by an insurance company. While insurance companies need experts to present their performance meaningfully to the public, stakeholders need professional advices for a meaningful interpretation of the same.

**Table-2**  
**Deposit Insurance and Credit Guarantee Corporation - Insured Deposits**

Year	Total amount of insured deposits	Total amount of assessable deposits
2005-06	109316	156892
2006-07	572434	806260
2007-08	674051	968752
2008-09	828885	1213163
2009-10	870940	1318268
2010-11	991365	1619815
2011-12	1052988	1790919
2012-13	1372597	2344351
2013-14	1805081	2984800
2014-15	1908951	3398565
2015-16	2369483	4282966

Long-term debt market: The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialisation of debt instruments in order to encourage paperless trading.

### CONCLUSIONS:

Despite robust economic growth, India continues to face several major problems. The recent economic development has widened the economic inequality across the country. Despite sustained high economic growth rate, approximately 80% of its population lives on less than \$2 a day (PPP), more than double the same poverty rate in China. Even though the arrival of Green Revolution brought end to famines in India, 40% of children under the age of three are underweight and a third of all men and women suffer from chronic energy deficiency. While the credit rating of India was hit by its nuclear tests in 1998, it has been raised to investment level in 2007 by S&P and Moody's. In 2003, Goldman Sachs predicted that India's GDP in current prices will overtake France and Italy by 2020, Germany, UK and Russia by 2025 and Japan by 2035. By 2035, it is projected to be the third largest economy of the world, behind US and China.

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