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Special Issue

"FINANCIAL SECTOR REFORMS IN INDIA"

(Banking Sector Reforms In India)

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INTRODUCTION

Financial sector is the backbone of any economy and it plays a crucial role in the mobilisation and allocation of resources. The constituents of the financial sector are Banks, Financial Institutions, Instruments and markets which mobilise the resources from the surplus sector and channelise the same to the different needy sectors in the economy. The process of increasing capital accumulation through institutionalisation of savings and investment fosters economic growth. The main objectives of the financial sector reforms are to allocate the resources efficiently, increasing the return on investment and accelerated growth of the real sectors in the economy. The measures initiated by the Government of India under the reform process are meant to increase the operational efficiency of each of the constituent of the financial sector. The discussion of the present text has been restricted to the role of the development banks in the era of reforms.

Financial Sector Reforms: A Summary

Financial sector reforms are at the centre stage of the economic liberalization that was initiated in India in mid 1991. This is partly because the economic reform process itself took place amidst two serious crises involving the financial sector:

%%the balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and

%%the grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies.

Moreover, many of the deeper rooted problems of the Indian economy in the early nineties were also strongly related to the financial sector:

%%the problem of financial repression in the sense of McKinnon-Shaw (McKinnon, 1973; Shaw, 1973) induced by administered interest rates pegged at unrealistically low levels;

%%large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit;

%%excessive structural and micro regulation that inhibited financial innovation and increased transaction costs;

%%relatively inadequate level of prudential regulation in the financial sector;

%%poorly developed debt and money markets; and

%%outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient.

Banking and credit policy

At the beginning of the reform process, the banking system probably had a negative net worth when all financial assets and liabilities were restated at fair market values (Varma 1992). This

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