

Financial Sector Reforms help improve Market Efficiency and Integration

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The Report on Currency and Finance for 1998-99 was for the first time designed to focus on a single theme as a subject for detailed analysis. The comments received on that report were generally favourable. Encouraged by this development the Report for 1999-2000 has been fashioned to set up a tradition of choosing a theme of critical contemporary value. The objective of a theme based approach to direct intensive policy oriented research into issues that emerge from the analytical treatment and empirical inquiry of the chosen theme, and to place these analyses in the public domain so as to offer to the readership a comprehensive, balanced and in-depth assessment of the subject against the background of current times.

The 1990s have arguably been the decade of the financial sector for the Indian economy. An integral element of financial sector reforms has been the gradual development of financial markets. Policy interventions in market processes have been progressively vacated to reap efficiency gains associated with the development of markets. But financial development is only a necessary condition for sustainable growth, and by no means a sufficient one. Financial stability has also to be given centre-stage in the designing of public policy. In view of the criticality of the working of the financial sector for the Indian economy, the Report focuses on "*Financial Sector and Market Integration*" as its main theme.

As the theme in the last Report was devoted to '*Structural Transformation of the Indian Economy*' and the period covered was since the 'eighties, a review of macro-economic developments for the year 1998-99 was integrated into the theme itself. However, as the theme of this year's Report is focussed on financial sector and market integration, an overview of the Indian economy during 1999-2000 and 2000-2001 (up to the latest available period) precedes the analysis of the theme.

Financial Sector reforms which have gained pace since mid-1991, have not only facilitated growth and development of the Indian economy, but also helped to improve the efficiency and integration of financial markets. These aspects have been highlighted in the Report on Currency and Finance, 1999-2000 released by the Reserve Bank of India today. The Report is available on the RBI web site: <http://www.rbi.org.in>

Current macroeconomic and financial developments in the Indian economy highlight the evolving role of the financial sector in the functioning of the economy and the growing integration across financial markets. In view of the criticality of the working of the financial sector for the Indian economy, the Report focuses on "*Financial Sector and Market Integration*" as its main theme, while providing an overall review of the recent economic developments.

The Report analyses the issues relating to financial development, financial market structure, financial integration and efficiency as also financial stability with reference to India. The Report provides a broad spectrum of indicators to show that the Indian financial system has become fairly deep over the last three decades or so. Among the two broad sources of finance, viz., intermediaries-based and market-based, the relative importance of the market-based finance has grown in the 1990s, even though the former continues to be the

main source of financing. Evidence suggests that financial development and economic growth reinforced each other.

It also discusses the various financial markets as it evolved during the 'nineties. In a market oriented economy, segmented markets could not only obscure the transmission of public policies but could also give rise to sub-optimal allocation of resources. The data presented in the Report indicate that financial markets in India which remained segmented for long are getting increasingly integrated both domestically and internationally, following initiation of financial sector reforms in the 1990s. It also analyses integration of domestic financial markets in terms of the linkages across the term structure of interest rates and between interest rates and other asset prices. Cross-border integration is studied through various indicators of openness to trade and finance as also the standard international parity conditions.

In order to ensure stability of the Indian financial sector, a wide array of measures has been adopted. The Report analyses the prudential indicators of the financial system, policy credibility and the policy response to achieve the requisite levels of transparency. The fiscal policy issues having a bearing on the financial stability have also been examined. The Report observes that the Indian financial system is reasonably stable with a median Capital to Risk-weighted Asset Ratio (CRAR) exceeding 11.0 per cent for the nationalised as well as the Indian private sector banks at the end of 1999-2000. However, high level of non performing loans in some banks and some financial institutions and debilitated discipline in some NBFCs is being addressed by the regulators putting in place a stricter supervision and regulatory system.

The Report examines financial sector efficiency, especially of the banking sector. It observes that efficiency of both markets and institutions has improved following competitive pressures resulting from deregulation of financial markets, advances in technology, blurring of distinctions among providers of financial services and integration of markets. There is some evidence that stock and foreign exchange markets in India are becoming informationally more efficient. Presence of noise traders could adversely affect the market efficiency; but the advances made in the electronic payment system are expected to significantly lower transaction costs and improve efficiency.

Reviewing the recent macroeconomic developments, the Report states that in 1999-2000, the real GDP growth at 6.4 per cent equalled the average achieved in the 1990s (excluding 1991-92, the year of adjustment). The growth performance of 1999-2000 occurred in a stable environment. Financial markets in India remained generally stable during the year. Different segments of financial markets exhibited a growing tendency towards integration viewed in terms of the movements in prices and turnover. In the current financial year, money market conditions were influenced by short-term developments in the currency market and policy interventions of the Reserve Bank aimed at promoting stability. The recently introduced liquidity adjustment facility (LAF) has facilitated the maintenance of orderly market conditions.

The Report is essentially a research document prepared by economists of the Reserve Bank. The Reserve Bank would greatly appreciate comments and suggestions in this regard.

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