IJESRR
International Journal of Education and Science Research Review
ISSN 2348-6457
www.ijesrr.org April- 2020, Volume-7, Issue-2 Email- editor@ijesrr.org

ECONOMIC REFORMS OF FINANCIAL SECTOR IN INDIA

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ABSTRACT:
The managers of the Indian economy found that the world has been sharply divided into two bocks: the one led by the capitalist economies and other led by the communist economies, primarily the then USSR. There was cold war between these two blocs. Less developed economies had no option than to join either of the two and invite the ire of the opposite bloc. Especially those economies that were under the British Empire and won freedom during 1940's faced a difficult choice. India chose to keep a safe distance from both the blocks by inventing the idea of a mixed economy. In doing so, India invited as much favor as suspicion from both the blocks. Some economists hold the opinion that the Indian economy was pro-capitalism in its core that wore the façade of a socialistic economy..
Key words: sharply, economics, pro-capitalism.

INTRODUCTION:

Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors. Since the Asian financial crisis of 1997-1999, the importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization has been increasingly recognized. The crisis was preceded by massive, unhedged, short-term capital inflows, which then aggravated double mismatches (a currency mismatch coupled with a maturity mismatch) and undermined the soundness of the domestic financial sector. A maturity mismatch is generally inherent in the banking sector since commercial banks accept short-term deposits and convert them into relatively longer-term, often illiquid, assets. Nevertheless, massive, predominantly short-term capital inflows – largely in the form of inter-bank loans – shortened banks' liabilities, thus expanding the maturity mismatch. Further, a currency mismatch was aggravated since massive capital inflows denominated in foreign currency were converted into domestic currency in order to finance the cyclical upturn of domestic. It is now widely accepted that capital account liberalization should follow current account and domestic financial sector liberalization (Mckinnon 1973).

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 1996.

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. Insurance penetration has witnessed commendable increase from 1.77 in the year 2000 to 4 in the year 2007 in life insurance sector. Non-life penetration has increased from 0.55 percent to 0.60 percent during this period.

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)
1990-91	271	76	787	678
2000-01	3205	261	5749	4874
2001-02	3687	261	6600	5453
2002-03	4683	261	7584	5999
2003-04	5037	259	8740	7079
2004-05	6942	475	11797	9363
2005-06	8077	641	14102	10284
2006-07	9767	954	17008	12194
2007-08	11809	1050	20853	14399
2008-09	14339	929	25515	17268
2009-10	16877	1661	29682	21532
2010-11	17432	1825	32342	24234
2011-12	19212	2123	34312	27235

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,

In the nine years since the Insurance sector was opened up in the year 2000, Insurance industry has witnessed a business growth of more than five times, from Rs. 4874 crore in 2000-01 to Rs. 27235 crore in 2011-12. Ever since, there has been paradigm shift in the meaning and relevance of 'Insurance' to the common man. 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
1990-91	109316	156892
2000-01	572434	806260
2001-02	674051	968752
2002-03	828885	1213163
2003-04	870940	1318268
2004-05	991365	1619815
2005-06	1052988	1790919
2006-07	1372597	2344351
2007-08	1805081	2984800
2008-09	1908951	3398565
2009-10	2369483	4282966
2010-11	2532231	4431421
2011-12	2741482	4621314

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.

The Government has to decide what it wants to do with its ownership of public sector financial institutions. Lack of funds will force its to divest its stake over a period, but this may mean only a slow death for the institutions involved. The political and bureaucratic establishment has to be convinced that they are doing more harm than good by interfering in the management of these institutions. Otherwise even after reduction of its equity stake to 33 per cent, the public sector character of banks will remain unchanged! Offices such as Department of Banking need to be wound up, with regulators taking control. Senior level appointments have to be made by the respective boards of directors by accessing the market place, and offering market related salaries and incentives. The board of directors, based on performance, should renew senior level appointments. The institutions should have the right to forcibly retire existing non-performing employees, and new staff should be recruited without guaranteeing life-time employment. Even the threat of action will improve performance and productivity.

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