Reforming India's Financial System

Its underdevelopment is hindering the country's economic growth.

By Diana Farrell and Susan Lund

With a gross domestic product that is growing by more than 7 percent a year, India has made remarkable progress since opening its economy, in 1991. The country has accomplished this feat despite the substantial handicap of an underdeveloped financial sector.

At about $900 billion, India's stock of financial assets—including bank deposits, equities, and debt securities—is one-fifth the size of China's (Exhibit 1).[1] The gap is widening: by 2010, China's financial stock will reach $9 trillion, while India's will remain below $2 trillion.

But in allocating capital, particularly to private companies, India's financial system is more effective than China's, largely because the market share of more efficient foreign and privately owned banks in India has crept up to 25 percent. Many nonperforming loans have been cleaned up, and while the true figure is hard to determine, they are now estimated at around 9 percent of all lending,[2] compared with up to 40 percent in China. India's stock market is booming, and its best companies list shares abroad.

Still, to finance economic growth, India must raise its investment rate substantially, as McKinsey Global Institute (MGI) research shows. If that is to happen, the financial system must mobilize savings more effectively—a goal that calls for reducing the government's fiscal deficit, which crowds out private investment, and for reforming banks and capital markets. The government resists these steps for fear of job losses. Ultimately, however, the effect would be to create hundreds of thousands of new jobs in the financial sector and to generate faster growth in the whole economy.

Elusive savings

Why is the stock of financial assets so small? Not because Indians save too little: although the country's gross national savings rate is half of China's, it isn't bad by international standards (Exhibit 2). Furthermore, chronic government budget deficits depress the savings rate. Despite the fact that Indians should save more, the main challenge is to capture more of the existing savings.

India nationalized banks in 1969 in order to provide banking service to the masses. But penetration is low: just 40 percent of households have signed up as borrowers or depositors. Deposits represent 60 percent of GDP, compared with 190 percent in China and 142 percent in Japan.

India's capital markets have hardly done better to mobilize savings. Retail investors are few, though the stock market lists roughly 5,000 companies, has a market capitalization that (at roughly 50 percent of GDP) is comparable to the eurozone's, and offers a variety of derivatives and other complex products. Corporate bonds make up 1 percent of India's stock of financial assets, compared with 10 percent in Thailand, 20 percent in Malaysia, and 30 percent or more in South Korea, the United States, and most of Europe.

Instead of putting money into financial assets, Indian households invest more than half of their savings in physical ones such as land, houses, cattle, and gold (Exhibit 3). In rural areas, the proportion is even higher. In fact, India's people—mistrustful of banks—are the world's largest consumers of gold. They possess $200 billion of it, equal to nearly half of the country's bank deposits, and last year bought $10 billion worth, nearly twice the amount of the foreign direct investment India received. Households could earn higher returns by investing in financial assets, and the country would be better off if savings were pooled to finance more productive investments.

Efficiency: India's advantage

Room for improvement remains, but the Indian financial system is better than its Chinese counterpart at allocating capital, as demonstrated by India's improving level of nonperforming loans and the amount of capital funneled to private industry. India's banks have made a big effort over the past two years to clean up nonperforming loans. Although the current level is still higher than it is in developed countries, it is a fraction of China's. Continuing to follow good lending policies will be vital. As the low interest rates that have recently kept some loans afloat start to rise, banks will probably be tested.

Private-sector companies in India have better access to funds than do those in China. Small and midsize enterprises account for 45 percent of India's bank loans to businesses and generate 23 percent of the industry's revenues. According to the World Bank, 54 percent of small and midsize Indian companies had access to bank overdraft facilities in 2002, as compared with 26 percent of Chinese ones.[3] All but 60 of the roughly 5,000 companies listed on the Bombay Stock Exchange are privately owned or foreign joint ventures, which together account for roughly 70 percent of its market cap. Private-sector companies represent a small fraction of the market cap of the Shanghai Stock Exchange.

Nonetheless, capital could be allocated more efficiently. The Reserve Bank of India still insists that priority sectors (such as agriculture and small business) receive at least 40 percent of all loans and advances and that 25 percent of all bank branches serve rural and semi-urban areas. These requirements distort lending decisions and operational efficiency. Of the loans to priority sectors, 23 percent, far higher than the level elsewhere in the economy, end up as nonperforming—evidence that the scale of this lending makes little sense (see "What Indian consumers want from banks").

What's more, "lazy banking" constrains lending. Interest rates in India fell constantly over the past decade, and as bond prices rose banks could make easy money by using deposits to buy government bonds financing the fiscal deficit. Windfall treasury gains made banks more profitable but crowded out lending and private investment. Indian banks hold government bonds equal to 46 percent of their deposits, far more than the statutory minimum and nearly equal to their lending.[4] In 2003, two-thirds of the new assets that India's commercial banks acquired were government securities. Over the past year, however, interest rates have stabilized and the banks are realizing that they must focus again on lending.

Financing the investment gap

A comprehensive MGI study of India's economy in 2000 found that it would have to increase the investment rate to at least 30 percent of GDP to grow by 10 percent a year.[5] Given today's investment rate—nearly 25 percent—an additional $35 billion is required. The government reckons that a further $100 billion will be needed over the next ten years to upgrade the country's crumbling infrastructure.

What should governments do to attract investment? See "The truth about foreign direct investment in emerging markets"

Domestic savings are the only plausible source of extra funding, so more of them must be mobilized. Foreign direct investment alone won't fill the gap: although China is the world's largest recipient, for example, the $60 billion it received in 2004 was only 10 percent of domestic savings. Indian policy makers, in contrast to China's, remain ambivalent about foreign direct investment; in 2004 India received just $5.3 billion of it. Even doubling this figure—which would require a major policy shift—could provide little more than 10 percent of the additional funds needed. The government has proposed using foreign-exchange reserves to finance infrastructure investments, but this move would add only $3 billion to $5 billion annually.

Four reforms will be needed if the financial system is to capture more of the country's domestic savings and to reduce the share financing the public debt.

Reduce the fiscal deficit

Cutting the deficit would raise India's savings rate and make room for more private investment. As opportunities to profit from government bonds fell, banks would also feel prompted to put more deposits into loans.

The 2000 MGI study showed that India's government could cut the deficit by 4 percent of GDP, thereby providing three-quarters of the $35 billion needed for additional investment.[6] Such a cut would require the privatization of most state-owned companies, both to stop the subsidies they receive and to reap the sales revenue. Politically, this move would be difficult for the government, which has slowed plans to privatize some key state-owned companies for fear of job losses. But India's policy makers could ease the transition for displaced workers by ensuring that they get targeted retraining and can cover lost income with wage insurance policies.

India's policy makers must crack down on the **informal economy** of businesses that contravene tax and regulatory requirements

To reduce the deficit, India will also have to collect additional tax revenues. Since the reforms began, in 1991, the central government's tax receipts have fallen to 9 percent of GDP, from 10 percent. In China, over the same period, they rose to 19 percent of GDP, from 15 percent.[7] India's move to enact a national value-added tax replacing myriad state and local imposts is an important first step because it greatly simplifies collection. But policy makers must crack down on the informal economy of businesses—estimated at more than one-quarter of India's economy—that flout tax and regulatory requirements.[8] Doing so will not only raise tax revenues but also level the playing field for more productive and law-abiding companies.

Increase bank penetration

India's banks must do better at offering personal financial services to attract household savings. Today they mostly compete for the profitable business of affluent households, but appealing to unbanked rural ones is equally important. Building more branches in the countryside, as the largest state-owned banks have, isn't effective. Banks must develop a keener understanding of what rural households need and offer new products and distribution networks to suit them.[9]

In a potentially important step toward bringing millions of the poor into the banking system, the government has proposed to let Indians buy virtual, or "paper," gold in denominations as low as $2—an alternative to investing in jewelry and coins.[10] Initially, banks would keep the gold to back up the paper; buyers (like people who purchase equity shares) could trade in it and get the current market value of whatever quantity they had bought. The goal is to let banks make loans based on their gold deposits, as they now do with cash deposits.

Another opportunity might come from revamping rural microfinance projects, which now mostly focus on providing credit to the poor but should also encourage them to open deposit accounts. Attracting money from Indian expatriates is an option too; they made net new deposits of $3.6 billion in 2004, bringing their total to $33.3 billion. Banks can do more to attract them by facilitating deposits abroad and remittances to families and by processing mortgage and utility payments for properties in India.

Reduce the cost of bank intermediation

More of the savings that India's financial system captures could finance investment if banks reduced their cut from matching savers and users of capital (Exhibit 4). Intermediation costs remain high mainly because state-owned banks, whose productivity is 10 percent of US levels, control three-quarters of bank assets. India's new private banks achieve an average productivity of 55 percent of US levels, and some of the best operate almost at world-class standards and list shares on the NYSE. Moving all Indian banks toward their productivity potential of 90 percent of US levels—an ambitious but achievable goal—would unleash $2.5 billion a year in savings. Interest rates could fall by 1 percent.

To achieve these gains, regulators must pursue reforms on several fronts. They should encourage consolidation, for example, particularly among smaller state-owned banks, and improve the corporate governance of banks by making their boards more independent and accountable. Other desirable moves include giving managers greater freedom to make operational reforms and easing the labor laws that prevent banks from rationalizing and redeploying their workforce, outsourcing back-office functions, and introducing productivity-based compensation. Bank regulators should also replace directed lending to priority sectors with market-based incentives, such as credit guarantees or loan subsidies. Regulators are considering many such reforms; the challenge is to move faster.

Perhaps the most politically contentious area is the role of foreign banks. Today they are not permitted to hold more than a 5 percent stake in any Indian bank, except when the central bank identifies weak private-sector institutions, which foreign banks can acquire outright. Moreover, their organic growth is constrained by restrictions on the opening of new branches. Those who defend these restrictions argue, with some merit, that state-owned banks need time not only to improve their operations before they face foreign competition but also to recover from the limitations imposed by directed lending and strict labor laws. But foreign banks bring credit-assessment and risk-management skills, as well as new technology and capital, and intensify competition. MGI research shows that foreign direct investment has uniformly positive effects on local economies.[11] The current plan not to open the banking sector to foreign direct investment until 2009 will substantially delay these benefits at a time when India's economy needs more financial capital to grow. As 2009 approaches, policy makers may find new reasons to postpone liberalization.

Develop the capital markets

Equity and corporate-debt markets open new sources of funding for businesses, cut their cost of capital, give savers new investment options, and are essential to financing pension programs. India's stock market already performs well. Now it must diffuse the success of certain companies, such as those in IT and business process outsourcing, throughout the economy. Pension reform will be important. Since April, nongovernment provident funds (employee pension funds) have been allowed to invest 5 percent of their new inflows in shares and 10 percent in equity-linked mutual funds. Over the next few years, this will funnel an additional 200 billion rupees ($4.6 billion) into the stock market.[12]

Surprisingly, given India's Anglo-Saxon legal and institutional heritage, the country's corporate-bond market is underdeveloped. To spur its growth, policy makers must improve liquidity and price transparency. The required steps include consolidating government debt issues to establish a better yield curve and improve liquidity, widening the government securities market to include nonbank participants, and letting dealers short-sell and thus take two-way positions. It will also be necessary to change the pricing of interest rate futures and to let banks trade them, to allow repurchase-agreement transactions in corporate bonds, and to develop the derivatives market. These reforms will allow India's capital markets to evolve in a more balanced way, complementing the banking system.

For India to continue on its current trajectory, reforming the financial system must become a priority. Although policy makers fear that reform will cost jobs, the opposite is true. Today India's banking sector generates 2.5 percent of GDP and employs 900,000 people. With full reform, it could generate up to 7.5 percent of GDP and employ 1,500,000 people, as well as boost investment and growth throughout the economy.

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Notes

[1]The figures for China cover the mainland only and exclude Hong Kong and Macau. If they were included, China's financial stock would exceed $5 trillion. See Diana Farrell, Aneta Marcheva Key, and Tim Shavers, "Mapping the global capital markets," *The McKinsey Quarterly*, 2005 special edition: Value and performance, pp. 38–47.

[2]Fitch Ratings, April 1, 2005.

[3]*India: Investment Climate Assessment 2004*, World Bank.

[4]"Adieu, Paresse?" *Economist*, September 11, 2004.

[5]Amadeo M. Di Lodovico, William W. Lewis, Vincent Palmade, and Shirish Sankhe, "India—From emerging to surging," *The McKinsey Quarterly*, 2001 special edition: Emerging markets, pp. 28–50.

[6]Amadeo M. Di Lodovico, William W. Lewis, Vincent Palmade, and Shirish Sankhe, "India—From emerging to surging," *The McKinsey Quarterly*, 2001 special edition: Emerging markets, pp. 28–50.

[7]"Sweatshops and technocoolies," *Economist*, March 3, 2005.

[8]Diana Farrell, "The hidden dangers of the informal economy," *The McKinsey Quarterly*, 2004 Number 3, pp. 26–37.

[9]David Moore, "Financial services for everyone," *The McKinsey Quarterly*, 2000 Number 1, pp. 124–31.

[10]Anand Giridharadas, "India hopes to wean its citizens from gold," *International Herald Tribune*, March 16, 2005.

[11]Diana Farrell, Jaana K. Remes, and Heiner Schulz, "The truth about foreign direct investment in emerging markets," *The McKinsey Quarterly*, 2004 Number 1, pp. 24–35.

[12]"Loosening up," *Economist*, February 3, 2005.

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