

Finance, Credit and Markets

The role of the financial system is to intermediate between lenders and borrowers and provide avenues for saving and help investors find their financing needs. The financial markets impact growth by channeling saving to firms and improving the allocation of capital. Moreover, efficient financial markets and institutions tend to lower search and transactions costs in the economy.

2. As the industrialized nations' economies grew in the eighteenth, nineteenth and twentieth centuries, their financial systems also grew in depth and breadth. In the 19th century, London achieved its status as the world's leading financial centre, because the financial sector had developed rapidly in order to serve the needs of British industry and British exporters. Similar is the case with 20th century New York which played a similar role in relation to the American economy.

3. The relationship between financial development and economic growth is a subject of debate. Some economists just do not believe that the finance-growth relationship is important. For instance, Robert Lucas asserted in 1988 that economists badly over-stress the role of financial factors in economic growth. Moreover, Joan Robinson declared in 1952 that "where enterprise leads, finance follows". According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands.

4. The well-known former editor of "The Economist" Walter Bagehot expressed this in 1873 as follows "In England, however, ... capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level".

5. However, it is now increasingly accepted that financial development has a positive effect on growth. Financial intermediation can affect economic growth by acting on the saving rate, on the fraction of saving channeled to investment, or on the social marginal productivity of investment.

6. The studies of McKinnon and Shaw in early seventies propounded that financial repression depresses growth; conversely, financial development should raise growth. A positive correlation between growth and indicators of financial development is well documented. A growing body of evidence suggests that financial institutions (such as banks and insurance companies) and financial markets (including stock markets, bond markets, and derivative markets) exert a powerful influence on economic development, poverty alleviation, and economic stability. This position holds good for India too.

7. It is imperative that our nation must achieve high economic growth to cater to growing aspirations of its people. To attain such growth large capital and efficient distribution of capital is needed which can only be possible through efficient and developed financial markets.

8. World Economic Forum has constructed an Index that measures financial development. Measures of financial development are captured across the seven pillars of the Index viz. Institutional environment; Business environment; financial stability; Banking financial services; Non-banking financial services; financial market; and financial access.

9. India is ranked 40th out of 62 countries in the World Financial Development Index in 2012. India's rank in the parameters assessed in the Index is as under:

Parameter	Rank 2012
Institutional environment	56
Business environment	55
Financial stability	46
Banking financial services	45
Non-banking financial services	9
Financial markets	28
Financial access	45

10. While there may be debate on the methodology of rankings and the relative importance one may give to these rankings, it is pertinent to recognize the fact that there is tremendous scope for improvement. There is a need for working together in building more efficient financial markets.

11. Characteristics of financial markets development *inter alia* include:

- a) Size of financial institutions and markets (financial depth)

- b) Degree to which individuals can and do use financial institutions and markets (access)
- c) Efficiency of financial institutions and markets in providing financial services (efficiency), and
- d) Stability of financial institutions and markets (stability)

12. Market development is also dependent on the structure of the market and preference of savers for intermediation. In Asian economies there is a marked preference for bank intermediation. Bank-based finance has a special role to play for many economies in need of capital, and thus helps to ensure a well-balanced growth process. Benefit of bank-based finance relates to the intrinsic nature of the banking business: some projects cannot be financed directly by the market on account of significant information asymmetries between the borrowers and potential lenders. Banks can bridge this gap thanks to their comparative advantages in the assessment and monitoring of investment projects, which contributes to overcoming information asymmetries. Further, the economic literature on "relationship banking" has demonstrated that banks can contribute to alleviating the impact of sudden economic shocks on their clients. Banks are, however, financial intermediaries that by nature add cost to the allocation of capital.

13. In Asian economies banking is a marvelous mechanism for channeling into productive investments the huge flow of household savings generated, since those countries including Mainland China,

have savings-to-income ratios that are three, four, or even more times than the countries in the West. For all its potential contributions to economic growth, banking remains fragile. The high leverage combined with their “extreme mismatch” of maturities (funding long-term assets with short-term and, in some cases, foreign currency-denominated liabilities) and reliance on demand deposits, makes them inherently vulnerable – and their economies to severe and recurring credit crunches.

14. Although banks play an important role in these economies by channeling funds from depositors to companies without access to capital markets, banking itself, says Nobel laureate Merton Miller from University of Chicago, is “ basically a 19th century technology”. Today’s emerging Asian economies do not have well-developed capital markets and so remain heavily dependent on their banking systems to finance growth. However, as Miller argues, countries should develop a well fleshed out set of financial markets and associated institutions.

15. According to an Asian Development Bank's study the initiatives to develop bond markets should focus on: (i) sustaining a stable macroeconomic environment with low inflation and stable interest rates (ii) developing a healthy government bond market that would serve as a benchmark for the corporate bond market (iii) completing the post-crisis agenda of banking sector restructuring (iv) improving corporate governance (v) strengthening the regulatory framework for bond market (vi) rationalizing tax treatment of bonds (vii) broadening

the investor base, and (viii) promoting the growth of regional bond market centers.

Indian Debt Market

Bank Credit

16. India has the distinction of long history of both banks and capital market. Economic history of India narrates how both have been vibrant in many important cities, though Mumbai has been dominating all others. Slowly and steadily, especially after nationalisation, the banking sector has emerged as THE source for investment funding.

17. In India, bank credit has been the significant contributor to the investment. Bank credit increased from ₹ 5 billion as at end March 1951 to ₹13 billion by March 1961, ₹47 billion by March 1971, ₹254 billion by March 1981, ₹1164 billion by March 1991, ₹5114 billion by March 2001, ₹39420 billion by March 2011 and ₹67352 billion by March 2014. What has been the contribution of capital market? During the 1970s, while capital market helped raising ₹10 billion worth of equity, bonds and debentures, banks extended credit worth ₹207 billion in that period. During the 1980s, the corresponding figures were ₹233 billion and ₹910 billion. In the 1990s, they were ₹1172 billion and ₹3950 billion respectively and in 2000s they were ₹2115 billion and ₹34206 billion respectively. In 2013-14, it was ₹556 billion and ₹9,556 billion respectively.

18. While the capital market has been disappointing, the private

placement market in the past twenty years has been good. Though the issues thereat had been predominantly in the form of bonds and debentures, the growth in size has been very reassuring. It gained popularity from mid 1990s; from 1995-96 to 2000-01, this market raised ₹752 billion, in the next ten years, it helped raise ₹7614 billion and in 2013-14, this market raised ₹3899 billion.

19. Thus, the primary engine for Indian investments is the credit market. Despite all our efforts to develop corporate debt market, and calibrated increase in foreign capital, credit market remains the bulwark of Indian investment scenario.

OTC Market

20. In India, the small size of the OTC derivatives market, low level of complexity in products and regulatory structure that mandates that validity of any OTC derivative contract is contingent on one of the parties to the transaction being a regulated entity, resulted in orderly derivatives market development and lessened the concerns with regard to systemic risk. The OTC derivative products were introduced in a phased manner keeping in view the hedging needs of the real sector. Reserve Bank has focused on improving transparency and reducing counterparty risk in the OTC derivatives markets and fostered development of robust market infrastructure for trading, settlement and reporting of transactions. As India is committed to implementation of the G-20 / FSB reforms, reasonable progress has been made in implementing the OTC derivative reform measures in India. The status of reforms is as under:

- *Standardization*: The process of standardization is planned to be undertaken gradually. CDS transactions are standardized in terms of documentation, coupon, coupon payment date, etc. IRS on Overnight Index Swap have been standardized from April 1, 2013. Other benchmarks in IRS would be standardized in a phased manner.
- *Central clearing*: Calibrated steps towards central clearing of OTC derivative transactions are being taken. More than 70% of IRS trades currently being centrally cleared without regulatory mandate. CDS market is still developing and it may take more time to achieve the necessary market activity to support central clearing of CDS transactions. Timeframe for guaranteed settlement of CDS will be mandated after a critical level of volume is attained.
- *Exchange or electronic platform trading*: Electronic platforms are available for transactions involving repos in Government securities, IRS, forward rate agreements and foreign exchange forwards. Report of the Working Group on Government Securities and Interest Rate Derivatives Markets (Chairman: Shri R. Gandhi) has also recommended introduction of an electronic swap execution facility (electronic trading platform) for the IRS market, and consider introduction of a CCP which may provide guaranteed settlement of trades executed through the electronic platform.
- *Reporting to trade repositories*: As per existing regulatory guidelines, banks and primary dealers report IRS/FRA and

