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India

Safe and sorry

DELHI

To achieve faster growth, India needs financial-sector reform

WHEN the fashionable comparisons are drawn between India and China, one industry where India normally comes out on top is finance. Its banks and capital markets are more open and efficient. Private institutions—such as ICICI Bank and HDFC Bank—are growing fast and are widely admired. And the central bank, the Reserve Bank of India, is a respected prudential regulator. Yet, marking two years of this government's tenure late last month, the finance minister, Palaniappan Chidambaram, singled out financial-sector reform as essential if India is to achieve its aim of sustaining economic growth of 7-8% a year.

He identified a shortage of credit as a big obstacle to growth and a shortage of capital in the banking system as the biggest constraint to increasing credit. It is doubtful, however, whether Mr Chidambaram's government is likely to undertake the reforms needed to generate the capital: mostly they involve the government allowing its own dominant role in the financial system to shrink.

The arguments for reform are bolstered by the publication this week of a report by the McKinsey Global Institute, the research arm of an American consultancy. It believes that the financial system is inefficient, and allocates most of its capital to the least productive parts of the economy. Correcting these shortcomings, it argues, could free $48 billion of capital a year, over 6% of GDP, and raise the growth rate by 2.5 percentage points a year.

According to McKinsey's Leo Puri, India's financial system is "healthier but punier" than China's, and is "the one sector that could hold India back". Indian banks lend only 61% of their deposits, compared with 130% in China (see chart). A broader measure of "financial depth" which includes other assets, such as shares, and corporate and government bonds, finds India at just 160% of GDP, compared with 220% in China.

Not only is there a shortage of finance. It is going to the wrong places. Banks are required to hold 5% of their reserves in cash and at least 25% in government debt. They also have to direct 36% of loans to "priority sectors", picked by the government to help small borrowers. These are often loss-making for the banks, and hence lower overall lending. Even with these rules, access to bank credit is very limited. In much of the countryside, usurious moneylenders still hold sway. So, even in its own terms of ensuring that India's poor have access to banking services, the system does not work.

State-owned banks control 75% of total banking assets, a share second only to that of China (83%) among the large developing economies. One obvious solution to the difficulties would be to make it easier for private and foreign banks to operate. It would also help if the government forced some of the 27 state banks to merge. But bank unions put up powerful resistance, as does the notion that, left to the market, Indians' access to finance would be even more restricted. It is hard to see how. ■