Unleashing India's Potential

The key is to modernize the financial system.

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A casual observer might infer from India's flourishing stock markets, fast-growing mutual funds, and capable private banks that the country's financial system is one of its strengths. But closer inspection reveals that tight government control over almost every other part is undermining the overall performance and curbing India's economic resurgence. If India is to sustain rapid GDP growth and spread its benefits more broadly, it needs a financial system that is comprehensively market-oriented and efficient.

The financial system's shortcomings largely fall into three areas. First, India's formal financial institutions attract only half of Indian households' savings, and none of the $200 billion they keep tied up in gold. Second, India's financial institutions allocate more than half of the capital they do attract to the least productive areas of the economy: state-owned enterprises, agriculture, and the unorganized sector (mostly made up of tiny businesses). The more productive corporations in India's dynamic private sector receive only 43 percent of all commercial credit. Third, India's financial system is inefficient in both of its main tasks of mobilizing savings and allocating capital. That means Indian borrowers pay more for their capital and depositors receive less than in comparable economies.

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These failings place a heavy burden on India's economy, and fixing them would give it an immense boost. Research by the McKinsey Global Institute (MGI) calculates that an integrated program of financial system reforms could add $48 billion to GDP each year (Figure 1). This would raise India's real GDP growth rate to 9.4 percent per year, from the current three-year average of roughly 7 percent. India's growth would be roughly on par with China's and just shy of the government's 10 percent target, and household incomes would be 30 percent above current projections by 2014, lifting millions more households than expected out of poverty.

WHERE THEY ARE SAVING

Not long into our study we discovered that, despite India's 130-year-old stock market, long history of private banks, and generally well-developed public institutions, the nation's financial system intermediates a surprisingly small amount of the economy's total capital. This is demonstrated by the relative shallowness of India's financial system, measured by the value of all financial assets in the country relative to GDP. At 160 percent, India's financial depth is significantly lower than that of other fast-growing Asian economies, notably China (Figure 2).

Closer examination revealed just how much of the savings and investment fueling India's economic growth occurs outside India's formal financial system. Indian households save 28 percent of their disposable income, but invest only half of these savings in bank deposits and other financial assets. Of the other half, they invest 30 percent in housing, and put the remainder—which amounted to $24 billion last year—into machinery and equipment for the 44 million tiny household enterprises that make up the economy's unorganized sector. This is despite the fact that, with a few exceptions, household businesses are below efficient scale, lack technology and business know-how, and have low levels of productivity. In 2005, Indian households also bought more than $10 billion worth of gold, arguably another form of non-financial savings, and are now the world's largest gold consumers.

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India's economy would grow faster if the financial system could attract more of the nation's savings and channel them into larger-scale, more productive enterprises. We calculate that a program of reforms that helped India's financial system to capture and invest more productively just half of the household savings now used for gold purchases and investments in subscale household enterprises could add $7 billion each year to GDP.

FINANCING THE LEAST-PRODUCTIVE INVESTMENTS

On the face of it, India's financial system is better at allocating capital than those in many other emerging markets. It has some high-performing private and foreign banks, and its stock of non-performing loans, at about 5 percent of all loan balances, is manageable. It has a well-run equity market that lists mostly private companies.

But a closer look reveals significant room for improvement. India's financial system in fact channels only a minority of the savings it does manage to capture to entrepreneurs in the private sector. The majority of funding goes to the government, and to those investments that the government designates as priorities. India's private corporations receive just 43 percent of total commercial credit—a level that has not changed much since 1999.

The rest goes to state-owned enterprises, agriculture, and the tiny businesses in the unorganized sector. This pattern of capital allocation impedes growth because state-owned enterprises are, on average, only half as productive as India's private firms, and require twice as much investment to achieve the same additional output. Productivity in agriculture and the micro-businesses of the unorganized sector is only one-tenth as high as in India's modern private firms, and investment efficiency is commensurately low.

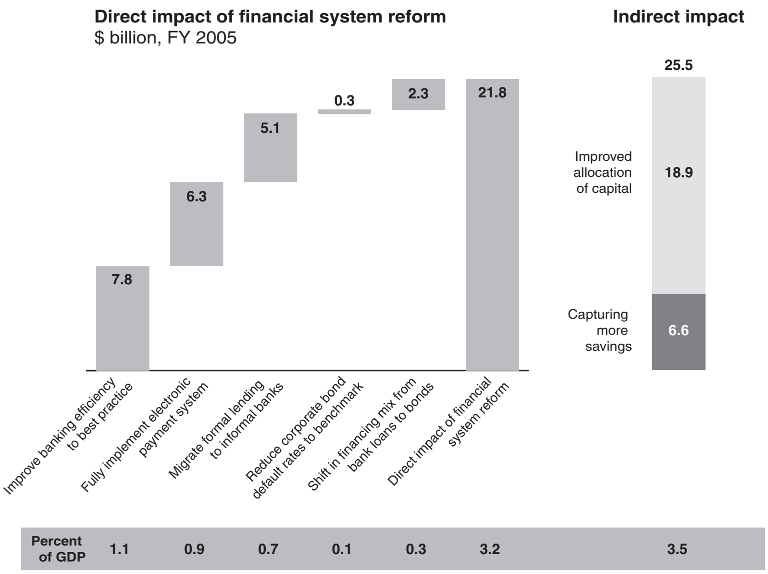
India's equity market, as we have noted, does a somewhat better job of funding the private sector—private company shares represent 70 percent of market capitalization. But new equity issues account for little of the funding raised by companies in any country, and in India, they amount to just 2 percent of the gross funds they raise. Not surprisingly, Indian companies rely heavily on retained earnings to fund their operations and investments—these account for nearly 80 percent of the funds they raise, a far higher level than in other Asian economies (Figure 3).

Reforms that enabled the financial system to channel a larger portion of credit to private companies would raise the economy's productivity. State-owned firms and household enterprises would need to improve their operations to compete successfully for finance. Accompanied by complementary reforms to India's labor and product markets, India would be able to get more output for each rupee invested with a resulting boost to GDP we calculate at up to $19 billion a year.

IN THE GOVERNMENT'S GRIP

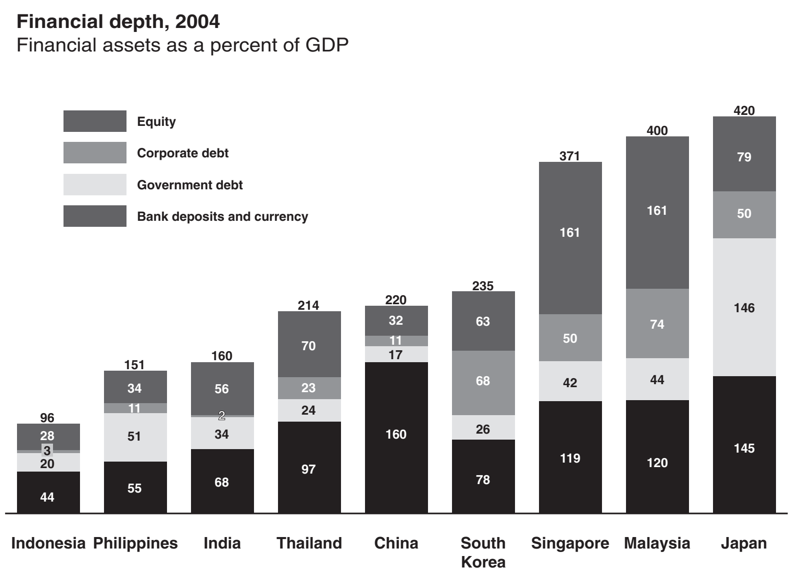
The government's tight control of India's financial system explains its poor allocation of capital. Regulations oblige banks and other intermediaries to direct a high proportion of their funding to the government, and to its priority investments. Banks have to hold 25 percent of their assets

1. Financial System Reforms Are Worth $48 Billion Annually



Source: RBI; CSO; McKinsey Global Institute analysis

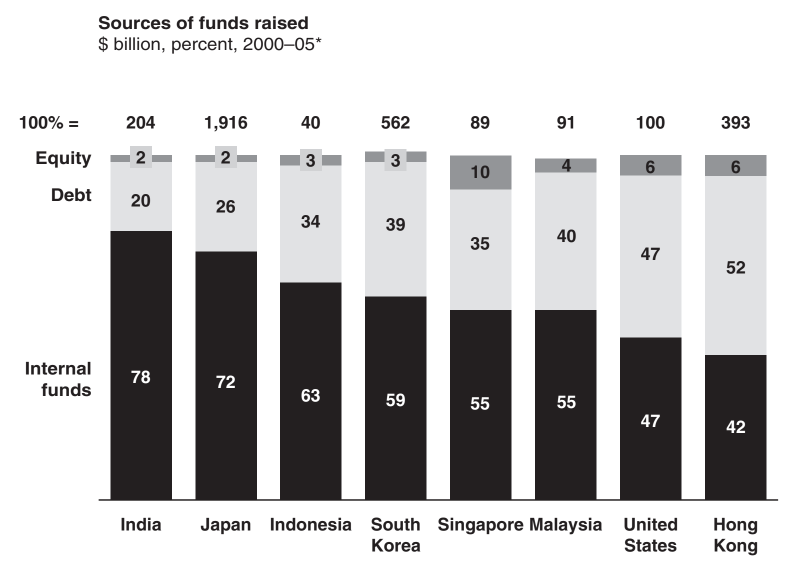
2. India's Financial Depth Remains Low Compared to Other Nations



Note: Numbers may not add due to rounding.

Source: McKinsey Global Institute Global Financial Stock Database; team analysis.

3. Indian Firms Rely Heavily on Retained Earnings



*Based on sample of 160 companies per country outside of United States. Companies were ranked by gross sales, and 40 companies from each quartile were taken as the sample. U.S. sample includes all listed companies with revenues exceeding $500 million, 1995 to 2004.

Source: Bloomberg; McKinsey Global Institute analysis.

in government bonds—and in practice, the state-owned banks that dominate the banking sector choose to hold even more. Government policies then require banks to direct 36 percent of their loans to agriculture, household businesses, and the state's other priority sectors. However, loans directed in this way have higher default rates than others and are more costly to administer because of their small size. As well as diverting credit from the more productive private sector, this policy also lowers lending overall, since banks' unprofitable directed lending has to expand in proportion with their discretionary lending. Not surprisingly, Indian banks lend just 60 percent of deposits, compared to 83 percent for Thai banks, 90 percent for South Korean banks, and 130 percent for Chinese banks.

Similar policies require that 90 percent of the assets of provident funds (essentially pension funds) and 50 percent of life insurance assets are held in government bonds and related securities. Without these rules, pension funds, mutual funds, and insurance companies would be an important source of demand for corporate bonds and equities in India, as they are in other countries.

These policies have allowed India's government and state-owned enterprises to absorb an astonishing 70 percent of the savings funneled into the financial system since 2000. Some of this funding flows to rural areas and to public sector enterprises to ensure that employment remains robust. But the government also maintains these policies to finance a persistently large budget deficit that, together with state deficits, has consistently averaged around 9 percent of GDP over the past 25 years, despite large variations in the macroeconomic environment over that time.

A COSTLY INTERMEDIARY

The government's influence on India's financial system also lowers its efficiency and raises the cost of financial intermediation. India has the highest level of state ownership of banks of any major economy today, apart from China—and even China is now seeking foreign investment in most of its major commercial banks. India's new private banks have a combined market share of only 9 percent. Foreign banks account for another 5 percent of deposits, but cannot expand because of limits on foreign investment in banking.

The prevalence of state-owned banks means that there is little competitive pressure to improve operations. These banks meet their costs by maintaining high margins between lending and deposit rates: bank margins are 6.3 percent in India, compared with an average of 3.1 percent in the case of South Korea, Malaysia, Singapore, and the United States.

Banks also face negligible competition from India's tiny corporate bond market, whose value amounts to just 2 percent of GDP. The reason the market has remained so small is a mass of regulations that unnecessarily raise the cost of issuing bonds, lengthen listing procedures, and increase disclosure requirements. To avoid these hassles, most Indian companies look for funding elsewhere. Some turn to private placements of debt, which total $44 billion—more than ten times the amount of publicly traded bonds. The largest companies also issue international bonds, despite the currency risk involved.

However, most sizable companies are forced to seek funding from banks, and this in turn crowds out bank

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lending to smaller companies and consumers, the banks' natural customers. If India were to develop a vibrant corporate bond market and the financial system were to offer the mix of bonds and bank loans seen in other emerging economies, India's companies—large and small—would enjoy substantially lower funding costs.

Even India's equity market is constrained by heavy regulation elsewhere in the financial sector. The market would function even better if domestic financial intermediaries, with their long-term mindset, held more shares—but they are currently required to invest in government bonds. Instead, corporate insiders own half of all shares, and this not only weakens the degree of market oversight but also potentially lowers the quality of governance. Retail investors own only 17 percent of shares, but account for 85 percent of trading—suggesting that they view the market as a gambling opportunity rather than a source of steady, long-term returns.

REFORM WILL SPUR GROWTH

The necessary reforms will primarily affect the banking sector, the corporate bond market, and India's domestic institutional investors. But the set of reforms must be carefully integrated, since many problems in India's financial system cut across its various markets. To achieve their full potential, reforms in one area will require complementary changes in others—for instance, changes in capital account and foreign investment policies.

Still, a single principle should guide the whole reform program. The government must loosen its grip on the financial system and allow financial institutions and intermediaries to respond to market signals. This means lifting directed lending policies and restrictions on the asset holdings of banks and other intermediaries, in order to release more capital for more productive investment in the Indian economy. It also requires reducing state ownership in the banking sector, developing a corporate bond market, and easing the many regulations holding back the development of pensions, mutual funds, and insurance companies. In addition to raising efficiency and returns, so doing will also enable intermediaries to create more attractive consumer financial products, draw a larger share of household savings into the financial system, and increase total investment in the economy.

Financial sector reforms are also needed to allow reforms of the rest of the Indian economy to succeed. To achieve higher rates of growth, both corporate and infrastructure investments must increase, and this will require a robust bond market to provide long-term funding, as well as more investment by foreign companies in many sectors. Faster growth will, in turn, necessitate a large increase in construction of both residential housing and commercial properties—and that will be impossible without similarly rapid growth in mortgage financing, which currently comprises only 3 percent of GDP.

Some of India's regulators are understandably resistant to financial system reform because they perceive it to involve risks and political trade-offs. They fear, for instance, that abandoning directed lending would stifle growth in the rural economy, potentially increasing rural unemployment. However, India's rural poor, as well as its entrepreneurs, would be better served if the financial system was free to allocate all its available capital to more productive businesses that can create waged jobs. If total liberation of the financial system seems a step too far, the government could, as a transitional measure, provide market-based incentives—such as tax breaks or subsidies—for banks to go on lending to priority areas rather than direct their lending by fiat.

Expanding the most productive parts of the Indian economy is, over time, not only the best way to increase the number of well-paid jobs and lift more people out of poverty, but also to fill the public purse. The last fifteen years of liberalization of the real economy have allowed India's economy to surge ahead. It is now time that the Indian government allowed its financial system to do the same. ◆