India’s financial system holds one of the keys, if not the key, to the country’s future growth trajectory. The financial system’s ability to efficiently intermediate domestic and foreign capital into productive investment and to provide financial services to a vast majority of households will influence economic as well as social stability.

While India’s financial institutions and regulatory structures have been developing gradually, the time has come to push forward the next generation of financial reforms. The needs of a growing and increasingly complex market-oriented economy, and its rising integration with global trade and finance, call out for deeper, more efficient and well-regulated financial markets.

Notwithstanding concerns about its depth and efficiency, the financial system seems to have enabled rapid growth and relatively moderate inflation. Arguably, it must be getting something right. Why fix what ain’t broke? There are three main reasons. First, the financial system is actually not working well in terms of providing adequate services to the majority of Indians, meeting the large-scale and sophisticated needs of large Indian corporates, or penetrating deeply enough to meet the needs of small and medium-sized enterprises. All of this will inevitably become a barrier to high growth. Second, the financial sector—if unleashed but with proper regulation--has the potential to generate millions of much-needed jobs and, more important, have an enormous multiplier effect on economic growth and the inclusiveness of the financial system. Third, in these uncertain times, financial stability is more important than ever to keep growth from being derailed by shocks hitting the system, especially from abroad.

Even if one accepts all of this, why now? After all, the world’s deepest and most sophisticated financial market seems to be imploding, and taking down many foreign financial institutions with it. Perhaps it is time for India to batten down the hatches, insulate itself from global finance, and not venture into sophisticated but apparently risky products. This is the wrong lesson to draw from the U.S. sub-prime mess.

The right lesson is that markets and institutions do succumb occasionally to excesses, which is why regulators have to be vigilant, constantly striking the right balance between attenuating risk-taking and inhibiting growth. Similarly, the right lesson to be drawn from the Asian crisis is not that foreign capital or financial markets are inherently destabilizing, but that weak legal frameworks and toothless regulation, especially if coupled with public corruption and weak corporate governance, can spell trouble. Financial sector reforms that lead to well-functioning competitive markets can reduce these vulnerabilities. Indeed, the U.S. equity, government debt, and corporate debt markets remain resilient, despite being close to the epicenter of the crisis.

But a robust financial system is not much good if most people don’t have access to it. Financial inclusion, which means providing not just basic banking but also instruments to
insure against adverse events, is a key priority in India. The absence of access to formal banking services, which affects more than one-third of poor households, leaves them vulnerable to informal intermediaries such as moneylenders. Government-imposed priority-sector lending requirements and interest rate ceilings for small loans have ended up restricting rather than improving broad access to institutional finance. Banks have no incentive to expand lending if the price of small loans is fixed by fiat. Consequently, nearly half of the loans taken by those in the bottom quarter of the income distribution are from informal lenders at an interest rate above 36 percent a year, well above the mandated lending rate. The solution is not more intervention but more competition between formal and informal financial institutions and fewer strictures on the former.

With so many difficult challenges, what is the way to proceed? One point to keep in mind is that many of the reforms are intertwined. For instance, it makes sense to level the playing field between banks and nonbank financial corporations by easing the requirement that the former finance priority sectors and the government. But making these changes while the government continues to have huge financing needs and without having a more uniform and nimble regulatory regime could be dangerous.

The connections, which stretch beyond just financial reforms to broader macroeconomic reforms, can in fact have a positive effect by reinforcing the effects of individual actions. For instance, the process of removing restrictions on capital flows could serve as an adjunct to other reforms if handled adroitly. Allowing foreign investors to participate more freely in corporate and government debt markets could increase liquidity in those markets, provide financing for infrastructure investment, and reduce public debt financing through banks.

India’s rich and complex political process being what it is, focusing solely on the big picture could bog down progress. A hundred small steps, many of them less controversial but still requiring some resolve on the part of policymakers, could get the process of reforms going and build up momentum for the bigger challenges that lie ahead. For instance, converting trade receivable claims to electronic format and creating a structure to allow them to be sold as commercial paper could greatly boost the credit available to small and medium enterprises.

We believe that if other policies are in sync, financial sector reforms could add significantly to economic growth and also make a major contribution to the sustainability of this growth, in both the economic and political dimensions. The absence of reforms would not only represent a lost opportunity but also a huge source of risk for the economy. The time to act is now.

Raghuram Rajan, a professor at GSB Chicago, was the Chairman of the Committee on Financial Sector Reforms. Eswar Prasad, a professor at Cornell University, was a member of the committee’s research team.