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### AN ANALYSIS OF FINANCIAL SECTOR REFORMS IN INDIAN ECONOMY

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#### ABSTRACT

India's banking reforms differ from those in other developing countries in one important respect, and that is the policy toward public sector banks that dominate the banking system. The government has announced its intention to reduce its equity share to 33.33%, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks. Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share. If privatization is not politically feasible, it is at least necessary to consider intermediate steps that could increase efficiency within a public sector framework, these include shifting effective control from the government to the boards of the banks, including especially the power to appoint the chairman and executive directors, which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these boards; implementing a prompt corrective action framework that would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breached; and acceptance of closure of insolvent public sector banks.