# Chapter-5

**Service Sector in Indian Economy**

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5.1 Banking and Finance Sector

The last decade witnessed the maturity of India's financial markets. Since 1991, every government of India took major steps in reforming the financial sector of the country. The important achievements in the following fields are discussed under separate heads:

- Financial markets
- Regulators
- The banking system
- Non-banking finance companies
- The capital market
- Mutual funds
- Overall approach to reforms
- Deregulation of banking system
- Capital market developments
- Consolidation imperative

[17 Main articles: Banking in India and Insurance in India web site]
Now let us discuss each segment separately.

**Financial Markets**

In the last decade, Private Sector Institutions played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market.

Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation added to it. The real interest rate was maintained. The borrowers did not pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.

**Regulators**

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity of regulators.

**The banking system**

Almost 80% of the business is still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges. The RBI has given licences to new private sector banks as part of the liberalisation process. The RBI has also been granting licences to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance.
The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.

Development finance institutions

FIs’s access to SLR funds reduced. Now they have to approach the capital market for debt and equity funds.

Convertibility clause no longer obligatory for assistance to corporate sanctioned by term-lending institutions.

Capital adequacy norms extended to financial institutions.

DFIs such as IDBI and ICICI have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures. The move to universal banking has started.

Non-banking finance companies

In the case of new NBFCs seeking registration with the RBI, the requirement of minimum net owned funds, has been raised to Rs.2 crores.

Until recently, the money market in India was narrow and circumscribed by tight regulations over interest rates and participants. The secondary market was underdeveloped and lacked liquidity. Several measures have been initiated and include new money market instruments, strengthening of existing instruments and setting up of the Discount and Finance House of India (DFHI).

The RBI conducts its sales of dated securities and treasury bills through its open market operations (OMO) window. Primary dealers bid for these securities and also trade in them. The DFHI is the principal agency for developing a secondary market for money market instruments and Government of India treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions.
On account of the substantial issue of government debt, the gilt-edged market occupies an important position in the financial set-up. The Securities Trading Corporation of India (STCI), which started operations in June 1994 has a mandate to develop the secondary market in government securities.

Long-term debt market: The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialization of debt instruments in order to encourage paperless trading.

The capital market

The number of shareholders in India is estimated at 25 million. However, only an estimated two lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavory developments, which have led to retail investors deserting the stock markets.

Mutual funds

The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign players.

The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.
The foreign owned AMCs are the ones which are now setting the pace for the industry. They are introducing new products, setting new standards of customer service, improving disclosure standards and experimenting with new types of distribution.

The insurance industry is the latest to be thrown open to competition from the private sector including foreign players. Foreign companies can only enter joint ventures with Indian companies, with participation restricted to 26 per cent of equity. It is too early to conclude whether the erstwhile public sector monopolies will successfully be able to face up to the competition posed by the new players, but it can be expected that the customer will gain from improved service.

The new players will need to bring in innovative products as well as fresh ideas on marketing and distribution, in order to improve the low per capita insurance coverage. Good regulation will, of course, be essential.

**Overall approach to reforms**

The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain (for example: lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market). On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.

However, financial liberalisation alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial
institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.

**Deregulation of banking system**

Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital were provided by the Government to PSBs.

Government pre-emption of banks' resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

New private sector banks allowed to promote and encourage competition. PSBs were encouraged to approach the public for raising resources. Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals set up to facilitate quicker recovery of loan arrears.

Bank lending norms liberalised and a loan system to ensure better control over credit introduced. Banks asked to set up asset liability management (ALM) systems. RBI guidelines issued for risk management systems in banks encompassing credit, market and operational risks.

A credit information bureau being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.

**Capital market developments**

The Capital Issues (Control) Act, 1947, repealed, office of the Controller of Capital Issues was abolished and the initial share pricing were decontrolled. SEBI, the capital market regulator was established in 1992.
Foreign institutional investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues.

The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading.

**Private mutual funds permitted**

The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialisation of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues.

To reduce the cost of issue, underwriting by the issuer were made optional, subject to conditions. The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices stopped and fresh guidelines were issued by SEBI.

SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and made rules for making client or broker relationship more transparent which included separation of client and broker accounts.

**Buy back of shares allowed**

The SEBI started insisting on greater corporate disclosures. Steps were taken to improve corporate governance based on the report of a committee.

SEBI issued detailed employee stock option scheme and employee stock purchase scheme for listed companies.
Standard denomination for equity shares of Rs. 10 and Rs. 100 were abolished. Companies given the freedom to issue dematerialised shares in any denomination.

Derivatives trading starts with index options and futures. A system of rolling settlements introduced. SEBI empowered to register and regulate venture capital funds.

The SEBI (Credit Rating Agencies) Regulations, 1999 issued for regulating new credit rating agencies as well as introducing a code of conduct for all credit rating agencies operating in India.

**Consolidation imperative**

Another aspect of the financial sector reforms in India is the consolidation of existing institutions which is especially applicable to the commercial banks. In India the banks are in huge quantity. First, there is no need for 27 PSBs with branches all over India. A number of them can be merged. The merger of Punjab National Bank and New Bank of India was a difficult one, but the situation is different now. No one expected so many employees to take voluntary retirement from PSBs, which at one time were much sought after jobs. Private sector banks will be self consolidated while co-operative and rural banks will be encouraged for consolidation, and anyway play only a niche role.

In the case of insurance, the Life Insurance Corporation of India is a behemoth, while the four public sector general insurance companies will probably move towards consolidation with a bit of nudging. The UTI is yet again a big institution, even though facing difficult times, and most other public sector players are already exiting the mutual fund business. There are a number of small mutual fund players in the private sector, but the business being comparatively new for the private players, it will take some time.

We finally come to convergence in the financial sector, the new buzzword internationally. Hi-tech and the need to meet increasing consumer needs is encouraging convergence, even though it has not always been a
success till date. In India organisations such as IDBI, ICICI, HDFC and SBI are already trying to offer various services to the customer under one umbrella. This phenomenon is expected to grow rapidly in the coming years. Where mergers may not be possible, alliances between organisations may be effective. Various forms of banc assurance are being introduced, with the RBI having already come out with detailed guidelines for entry of banks into insurance. The LIC has bought into Corporation Bank in order to spread its insurance distribution network. Both banks and insurance companies have started entering the asset management business, as there is a great deal of synergy among these businesses. The pensions market is expected to open up fresh opportunities for insurance companies and mutual funds.

It is not possible to play the role of the Oracle of Delphi when a vast nation like India is involved. However, a few trends are evident, and the coming decade should be as interesting as the last one.
5.2 Insurance sector

The insurance industry has grown by 83 per cent since the opening up of the sector. Remarking on the performance of the insurance industry, C S Rao, chairman, Insurance Regulatory & Development Authority, said public sector players have not suffered with the opening up of the sector.

Insurance premium income has risen to Rs 82,415 crore (Rs 824.15 billion) in 2003-04, against Rs 45,000 crore (Rs 450 billion) in 2000-01. Rao expects premium income in the life insurance sector to rise further by 15-16 per cent and non-life insurance premium by 14 per cent in 2005-06. The growth comes on the back of healthy demand from the manufacturing sector.

"There has been no reduction in growth rates as seen in the case of the Life Insurance Corporation of India. It is able to hold on to its existing share in terms of business growth. Market share is bound to stand reduced as some business goes to the private players," said Rao.

The health and personal line segments are expected to see maximum growth during the current financial year.

"The health insurance sector is expected to grow by 10-15 per cent," Rao said at a one-day seminar on ‘Growth of Insurance Industry in India’ organised by the Indian Merchants' Chamber in Mumbai on Friday.

If the cap on foreign direct investment is increased to 49 per cent from the current 26 per cent, the industry can expect greater entry of players. But this, said Rao, should not be seen as a threat to public sector players.

Insurance has always been a politically sensitive subject in India. Within less than 10 years of independence, the Indian government nationalized private insurance companies in 1956 to bring this vital sector under government control to raise much needed development funds.

Since then, state-owned insurance companies have grown into monoliths, lumbering and often inefficient but the only alternative. They have been
criticized for their huge bureaucracies, but still have millions of policy holders as there is no alternative.

Any attempt to even suggest letting private players into this vital sector has met with resistance and agitation from the powerful insurance employees unions. The Narasimha Rao government (1991-96) which unleashed liberal changes in India's rigid economic structure could not handle this political hot potato. Ironically, it is the coalition government in power today which has declared its intention of opening up insurance to the private sector. Ironical because this government is at the mercy of support from the left groups which have been the most vociferous opponents of any such move.

No policy initiatives have yet been announced, but the government has already clarified it will not privatize the existing insurance companies. But while the decision has been welcomed by the big companies who were planning to make a foray into this lucrative business, the move has been criticized by trade unions and even some left supporters of the government.

In some ways it was inevitable-all segments of the financial sector had been opened to private players and it was only a matter of time before insurance followed. The bigger private players claim that opening up insurance will give policy holders better products and service; the opponents of privatization argue that in a poor country like India insurance needs to have social objectives and newcomers will not have that commitment.

Many international players are eyeing the vast potential of the Indian market and are already making plans to come in. But it will take some time before the intent translates into policy-the unions are not going to give up without a fight and in that they will get the support of some elements of the coalition government.
5.3 Which Services have Grown Rapidly?\(^{18}\)

Table-1 provides information on growth rate in different segments of the services sector. Some segments grew at a rate much faster than their past average growth rates, while for some other segments, growth rates were similar to the past trend. Gordon and Gupta term the former as fast growers and the latter as trend growers.

**Table 1**  
Sectoral share of GDP in per cent

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**Table 2**  
Contribution of different sectors to GDP growth

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**Source:** (1) For columns (2), (3) and (4), Sunil Jain and T. N. Ninan "Servicing India's GDP Growth", Table 10.2, p. 335 and (ii) For columns (5), (6) and (7) Shankar Acharya, "Macroeconomic Performance and Policies, 2000-08", in Shankar Acharya and Rakesh Mohan (ed.), India's Economy - Performance and Challenges (New Delhi, 2010), Table 4.2, p. 120.

\(^{18}\) Mishra & Puri, Indian Economy, 2010, Himalaya Publication, Pg. No.441
Table 3
Growth rates and shares of service sub-sectors in GDP

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<td>(1.6)</td>
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Note: 1. 'Personal services' include domestic, laundry, barber, beauty shops, tailoring, others.
2. 'Community services' include education, research, scientific, medical, health, religious and other community.
3. 'Other services' include recreation, entertainment, radio, TV broadcast, sanitary services.

Source: Information in the last column has been computed from CSO, National Accounts Statistics 2009, information contained in earlier columns is from Jim Gordon and Poonam Gupta, "Understanding India's Services Revolution", IMF Working Paper, 2003, Table 5, p. 13.
1980s), while the contribution made by the fast growing activities was only about half the size. As against this, fast growing activities made about the same contribution to services growth in the 1990s as the trend growing sectors. In fact, argue Gordon and Gupta, “Since the trend growing sectors grew at about the same rate in both decades, the fast growers collectively accounted for almost all the higher growth in the 1990s.” One of the important reasons for this is that a number of new activities and industries have sprung up in the fast growth sub-sectors but not in the trend growth ones.

What Explains Rapid Services Growth?

The main reasons for rapid services growth in the Indian economy in recent years are generally discussed under the following headings:

Splintering

It is argued that as an economy matures, increasing specialization takes place. Industrial units tend to outsource some activities which were previously undertaken by themselves. For example, they may use greater services of specialist sub-contractors to provide accounting, research and development, legal and security services, etc., which were earlier undertaken by themselves. Bhagwati (1994) calls this process of specialization splintering. Kravis (1982) has argued that splintering leads to a growth in the share of services in GDP. Even when the GDP itself is not growing. This is due to the reason that the jobs outsourced will now be counted as service sector contribution to GDP, rather than being subsumed in manufacturing value-added.

However, Gordon and Gupta (2003) have argued on the basis of admittedly limited data. That the impact of splintering has been overstated. They use input-output coefficients to measure the increase in the use of outsourced services. Their study considers the input-output matrix for 1993-94. With the help of this matrix, they find that splintering added around 0.5 percentage point to services sector growth during the decades of 1990s, Nirvikar Singh (2006) repeated the analysis for 1990s using input-output
coefficients constructed from 1998-99 data and obtained the result that splintering essentially made no contribution to growth during the 1990s. No study for the period after 1990s is available. However, since the biggest rise in services after 2000 was in sectors like communications and IT, neither of which is related to Indian industries outsourcing their work to independent service units, it can perhaps be said that the role of splintering is insignificant.

However, as correctly pointed out by Nirvikar Singh, the above method of measuring the effect of splintering does not permit an analysis of the extent to which cross country splintering, which became important during 1990s and afterward (as through offshore outsourcing of business services), would explain the observed patterns of services sector growth. This is due to the reason that cross-country splintering implies a real shift in economic activity to India, whereas domestic splintering is more of an accounting change. Even in the case of domestic splintering, opines Singh, when specialization leads to efficiency improvements, it may well reflect a positive economic change.

**Demand side impetus to Growth**

During recent period, the demand side impetus to services growth is clearly visible. Till the liberalization of the early 1990s, the trend in private final consumption expenditure was a straightforward one – the share of services in the total consumption basket (at 1999-2000 prices) increased by about 3 percentage points each decade: that is, from around 8 per cent in 1950-51 to 11 per cent in 1960-61; 14 percent in 1970-71 percent in 1980-81; and 20 percent in 1990-91. However, thereafter, this trend changed significantly and by 2000-01, the share of services in private consumption rose to as much as 31 percent that is up by 10 percentage points. By 2006-07, it rose by another 8 percent points, indicating that the pace had quickened up further in the 2000s. These data clearly indicate a demand side impetus to growth of services. Sunil Jain and T. N. Ninan are of the view that this demand side impetus will not only continue in future but will also become stronger. They specifically mention increasing private expenditure on education, communications, medical care and health services.
The demand side impetus has also come from foreign sources particularly the IT/ITES (information technology and information technology enabled services) sector as, due to cost advantages in India, many companies in the developed world have started outsourcing certain services to Indian companies on a large scale. This has enabled exports of services from India to increase from only $4.9 billion in 1992 to as high as $101.2 billion in 2008-09.

**Role of Policy Liberalization**

The post-reform period (the period since 1991) has considerably liberalised the industrial and trade policies and opened up the banking, insurance, transport and communication sectors to private participation. Many economists have argued that this liberalization has boosted the growth of the services sector significantly. Sunil Jain and T. N. Ninan have shown that the fast-growth areas in services in the post reforms period have been those that have witnessed significant liberalisation. Even in the technology-driven sectors (such as IT and communication), the removal of government-imposed constraints has been important, if not vital, for growth. In this context, the examples of communication services, banking services, insurance services, and computer related services clearly stand out. As is clear from Table 35.4, the share of communication services in GDP rose considerably from 1.0 per cent in 1991 to as high as 5.7 per cent in 2007-08. This was primarily due to telecom liberalisation which began in 1994 when the private sector was allowed entry. In 1999, the share of the private sector in total telephone connections was a meagre 5 per cent. By December 2009, this had increased to as much 82.3 per cent. A revolution of sorts has taken place in the field of mobile telephony with the number of wireless connections increasing at a compound annual growth rate (CAGR) of 60 per cent per annum since 2004. This has been primarily due to increased role of private players. With 525.1 million wireless connections, Indian telecom has become the second largest wireless network in the world.

As far as the banking sector is concerned, its share in GDP almost doubled in the post reform period (its share was 3.4 per cent in 1990, 6.3 per
cent in 2000 and 6.0 per cent in 2007-08). As a result of the policy of liberalisation, the private banks have started playing an important role in the spread of banking facilities and this has given an impetus to the growth of the banking sector. While private banks accounted for just over 5 per cent of all bank incomes in 1995, their share rose to almost 25 percent in 2007. In insurance, within just seven years of the sector opening up, there were 24 private firms in 2006-07 who brought in Rs. 9,625 crore as capital.14 Liberalisation had a positive influence on computer related services (broadly the IT/ITES sector) whose share in GDP rose from 0.96 per cent in 1999-2000 to 3.04 per cent in 2006-07, while its contribution to growth was around 7.0 per cent.

**Technological Advances**

Services sector growth can also be stimulated by technological advances, whereby new activities or products emerge as a result of technological breakthrough. Such technological advances that appear to have had a positive impact on growth in India are the increasing use of internet in the case of the IT sector, expansion of cellular phone services in the telecom sector and use of credit cards, ATMs, etc., in the case of the banking sector. Gordon and Gupta have used a growth-accounting exercise to estimate a 1.25 percentage points contribution of policy liberalisation and technology progress to services sector growth in India.

**Mutual Dependence of Industrial and Services Growth**

Gordon and Gupta also find positive impact of industrial growth on services growth. The reverse direction examines the impact of services on manufacturing production and productivity. In this context, Nirvikar Singh quotes a study of Banga and Goldar (2003) which estimates that, although service inputs contributed little to the production of the registered manufacturing sector during the 1980s (only 1 per cent of output growth), the contribution of services increased substantially in the 1990s (to about 25 per cent of output growth). This, in turn, implies that excluding services inputs overstates the extent of manufacturing total factor productivity (TFP) growth in
the 1990s. These results suggest that the increasing use of services in manufacturing in the 1990s favourably affected TFP.

**Share of Services in Employment**

Although the services sector has grown at a fast rate during recent times and accounts for more than half of GDP (presently it accounts for around 57-58 per cent of GDP), its share in overall employment continues to be very low and is less than one-fourth of the total. In fact, during 1990s while the share of services in GDP rose from 42.0 per cent to 48.0 per cent, the share of services in employment actually declined by about one percentage point (from 24.4 per cent in total employment in 1990-91, the share of services fell to 23.5 per cent in 1999-2000). This indicates that India witnessed a relatively jobless services sector growth during 1990s. According to Gordon and Gupta, this is unlike the experience of other countries, where the services sector has also tended to gain a larger share of employment over time. When compared with other countries, India has an exceptionally low share of services employment.

In order to focus upon the differences in growth rate of employment and gross value added in services sector since 1970-71, a difference of means test was employed by the Report on Currency and Finance, 2001-02, with the following null hypothesis (i) there is no difference in the growth rate of employment in services sector and growth rate of gross value added in services sector; (ii) there is no difference between labour productivity growth and employment growth in services sector. Labour productivity was defined as value added in services sector divided by total labour in services sector.

The results show that hypothesis (i) can be rejected; i.e., growth rates of employment and value added in services sector are statistically different from each other during 1971-72 to 1999-2000. As the mean difference is negative decade and a half, large number of export and import items have been decanalised. Decanalisation of imports and exports is an important step towards opening of more areas of the external sector to the private sector. The government has also introduced a number of export promotion measures in recent years. These include establishment of Export Oriented Units for
promoting exports from the agricultural and allied sectors, simplification of Export Promotion Capital Goods Scheme, introduction of Export Promotion Capital Goods scheme for the services sector, adoption of a more rational and convenient criterion for recognition of export houses/Trading houses/Star Trading houses, broadening of areas of activity in Export Processing Zones, duty free import for exports under the advance licensing scheme, setting up of Special Economic Zones (SEZs), and creation of an exporters’ grievance cell in the Ministry of Commerce to facilitate action on problems being faced by exporters. Besides these, some more schemes/ measures have been introduced to accelerate the country’s transition to a globally-oriented economy, to stimulate growth by providing access to capital goods, intermediates and raw materials, and to enhance technological strengths of the economy thereby improving the global competitiveness of Indian exports.

The government has also liberalised capital flows in the form of foreign direct investment (FDI) as a part of the package of external sector reforms. Foreign companies are now allowed to use their trade marks, accept appointment as technical or management advisers, borrow and accept deposits from the public and repatriate profits etc.
5.4 Financial Sector Reforms

A vibrant, efficient and competitive financial system is necessary to support the structural reforms in the real economy. As pointed out by the Tenth Five Year Plan, “An important outcome of financial sector reforms is that it contributes to greater flexibility in the factor and product markets. With the real sector becoming increasingly market driven and engulfed by a competitive environment there is need for a matching and dynamic response from the financial sector.” This is possible only if the productivity and efficiency of the financial system improves. Keeping this in view, the government set up Committee on the Financial System in 1991 and on Banking Sector Reforms in 1998 (Narasimham Committees).

The Committee on Financial System was asked to examine the country’s financial system and its various components and to make recommendations in respect of the following:

1. For improving the efficiency and effectiveness of the Financial System, with special reference to economy of operations, accountability and profitability.

2. For infusing greater competition into the financial system so as to enable the banks and other financial institutions to respond more effectively to the credit needs of the economy.

3. For ensuring appropriate and effective supervision over the various entities in the financial sector, in particular the commercial banks and term lending institutions.

The Committee was also required to review the existing legislative framework and to suggest necessary amendments for implementing the recommendations.

The report of the Narasimham Committee on Financial System was placed before the Parliament in December 1991, and since then it has
become a basis for introducing reforms in the banking sector. The major reform measures undertaken during the past few years are as follows:

1. The level of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR) were progressively raised during the 1980s for combating inflationary pressures generated by large budgetary deficits. This, however, adversely affected the profitability of banks and pressurised them to charge high interest rates on their commercial sector advances. The government has over the years brought down both statutory liquidity ratio and cash reserve ratio in a phased manner. The effective statutory liquidity ratio has been lowered down to 24 per cent with effect from November 8, 2008. The cash reserve ratio was also brought down to 4.5 per cent with effect from June 14, 2003. However, to check liquidity overhang in the system the RBI hiked the CRR to 5 per cent in October 2005. It was raised in phases and stood at 9 per cent on August 30, 2008. However, because of slowdown in the economy during the latter half of the financial year 2008-09 following global recession, CRR was lowered in stages and brought down to 5.0 per cent with effect from January 17, 2009 in a bid to increase credit growth. To check inflationary pressures in the economy, the CRR was again raised in phases to 6.0 per cent from April 24, 2010.

2. The RBI introduced new prudential norms in respect of income recognition, classification of assets, provisioning of bad debts and capital adequacy. The minimum capital standards were prescribed in accordance with the Basel Committee norms under which banks were required to maintain unimpaired capital funds equivalent to 8 per cent of the aggregate of the risk weighted assets. Banks were expected to touch 8 per cent capital to risk weighted asset ratio (CRAR) by March 1996.