CHAPTER I

CORPORATE FINANCING AND FINANCIAL LIBERALISATION:
THEORIES AND DEBATES

1.1 Introduction

The process of financing growth remains a source of controversy in policy debates around the world today. Till recently, the dominant view was the neo-Keynesian argument that interest rates should be kept low to promote capital formation in the economy. This led many countries to adopt a highly interventionist financial system, with government controls on the methods of raising finance for investment and for directing it to desired channels. These controls were in the nature of fiscal and monetary controls like taxation, credit rationing and interest rate controls.

The 1980s saw a sea change in all these policies, largely influenced by the work of McKinnon1 and Shaw2 and the changing approach of the Bretton Woods institutions towards developing countries. These studies highlighted some of the lacunae of highly intermediated economies, whose financial systems they referred to as being 'financial repressed'. They argued that the seriousness of 'government failure' in command and control regimes was of a higher consequence than 'market failure', and advocated an alternative policy of financial liberalisation.

Subsequently, however, the strategy of sweeping financial liberalisation was found to be problematic in many countries which adopted it, since it was increasingly associated with foreign exchange crises and capital market failures. Taking note of these experiences, and also using the advantage of being a relatively late starter in terms of such liberalisation, Indian policy makers have been cautious in moving towards the full convertibility of currency, which forms the link between the domestic sector and international markets.

The neo-liberal strategy with respect to financial systems can be looked at, in terms of two broad effects which it has on the economy. These effects are in the

nature of changes in both the domestic and the international funding pattern of industries. The present study is an attempt to look at the effects of the financial liberalisation in India carried out in the early 1990s. It concentrates on the domestic effects of financial liberalisation, with particular focus on the new issue (primary) market (NIM) in India.

Before undertaking this analysis, however, it may be necessary to understand some of the theoretical and policy issues relating to the financing of the private corporate sector (PCS). Hence, this chapter is divided into two sections. The first section reviews some of the major theoretical discussions on financial liberalisation, covering both indirect funding activities through banks and development financial institutions (known as financial intermediaries), and direct funding activity i.e., via stock markets (the process of disintermediation). The second section is concerned with industrial policy and financial liberalisation measures in India.

1.2 Intermediation and External and Internal Capital Flows in Firms

In the literature on financial systems, there has been much discussion of the merits and demerits of two alternative strategies of resource allocation in an economy. The differentiating feature of these strategies is the differential role allotted to intermediary institutions between savers and investors. This process of intermediation creates what are known as financial assets. As observed by Bhatia and Khatkhate (1975), with economic development, since the distribution of savings among economic units does not always correspond to the distribution of investment expenditure among them, a dichotomy emerges between the decision to save and the decision to invest. In an extreme case, if all sectors are self-sufficient, then there will be no need for financial assets. In this situation, there would be no need for external financing, and thus, no need for a capital market or banks and DFIs. Such a situation would also exist if all transactions between the surplus and deficit sectors are carried through “book entries”, with no market forces operating in between.

3 Financial assets are defined as bank deposits, company deposits, treasury bills, national saving certificates, equity & debentures of various forms, etc.
5 The system which existed before the disintegration of the USSR.
assets arises only when an economic sector's investment exceeds its internal resource generation capacity (i.e. savings).

The financial asset itself is a piece of paper, which indicates the size and nature of the liability of a deficit sector vis-à-vis the surplus sectors. This deficit is financed either by borrowing or through the issue of stocks, the difference between these two financial assets being defined by differences relating to ownership and guarantee of returns. As our analysis is on the financing patterns of the private corporate sector, the following discussion limits itself to the liabilities created by it.

Financing in the private corporate sector (PCS) can be divided into two broad classes: internal sources of financing (such as reserves and surpluses) and external sources of financing (such as equity, debentures, venture capital, lease financing and short & long term loans). Various studies have provided alternative theories on the factors determining the use of these two major sources of financing by a firm. The idea that limited access to external financing constrains the investments made by corporate firms is not a new one. This idea has been well researched by Fisher, Gurley and Shaw, Duesenberry, and Mayer and Kuh. But, what is new in recent work relating to this theory is the provision of a micro-foundation for a theoretical analysis of the issue. This development is seen in a large body of literature like the works of Stiglitz and Weiss, Myers and Majluf, Greenwald, Stiglitz and Weiss, Bernanke and Gertler, and Gertler. All these studies concentrated on firm-level factors that rendered external sources of finance viable alternative sources of financing, without which, firms' investments would have been lower.

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6 Three broad economic sectors of the domestic market are government, private corporate and the household sectors.
On the issue of the relative role of internal and external sources of finance in investments made by firms, the study by Fazzari, Hubbard and Peterson (1988) suggested that the results obtained would vary depending on the type of firm. As the relative cost of internal funds is substantially lower than external funds, firms would normally prefer to use internal funds. But, in the case of a firm which has exhausted its internal resources, the effects of imperfect capital markets on investment financing are greater, and some firms are relatively more sensitive to fluctuations in external cash flow than others which pay high dividends. The study suggested that capital market imperfections have a binding influence on investments by firms.  

**Figure 1.1 : Investment Financing Decisions of a Firm**

![Investment Financing Decisions of a Firm](image)


Such constraints operating on firms are reflected in the hierarchy of financing illustrated in Figure 1.1, which lays out the choices both with respect to internal and external financing, and between debt and equity in external financing. The figure suggests that with increasing levels of investment, the firm always moves from internal financing to debt financing and finally, to new equity financing in that order. This supported the argument of Donaldson and Mayer on the "pecking order" of financing.  

Thus, the priority of financing of a firm which has alternative choices, would look like the one in figure 1.1.

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The studies by Paul and David\textsuperscript{18}, Glen and Pinto\textsuperscript{19}, and Ronald and Korwar\textsuperscript{20} have tested for implied cost differences between internal and external equity financing, also suggesting "financing hierarchies" in investment financing. What compels firms to use the last option is the lack of choice between internal and external financing and the relative cost difference between debt and equity. But, in most developing countries, where firms are relatively smaller in size and hence are characterised by weak management and low technological skills, capital scarcity on the internal front adds to the severity of external financing constraints. Consequently, this puts a lot of pressure on firms turning to debt as an instrument of financing, and it becomes a costly choice due to the high default risk of these firms (as perceived by the market). Thus, in a liberalised developing country with no controls on banks' interest rates, equity becomes the best option for domestic firms.

In a study, Singh (1995) suggested the following: a) unlike the US and the UK, stock market development in the industrialising countries today is not a spontaneous response to market forces; b) the cost of equity fell sharply due to large increase in share prices, which, combined with liberalised interest rates made equity issues more attractive for financing corporate growth; c) the supply curve of securities in the developing countries is reasonably elastic; d) there was an international and domestic element in the increase of the price-earnings (P/E) ratio during this period.\textsuperscript{21} All these could have led to the emergence of equity markets in many developing countries during the 1980s,\textsuperscript{22} suggesting an expansion of the last option (equities) mentioned in figure 1.1. This appears to contradict the conclusion derived on the financing order of firms, which postulates that equity would be the last choice in financing.

In many developing countries, equity boom was a consequence of financial liberalisation carried out since the 1980s. Most of the developing countries faced a problem of capital scarcity and so traditionally, intermediation was carried out in these

\textsuperscript{22} Glen and Pinto, Ibid.
countries within a broad welfare framework to direct capital in the most productive manner. Under liberalisation in many of these countries, however, many of the centralised and command economy activities were relaxed and removed gradually. There was a transformation in the resource allocation process from credit market-based to a capital market-oriented system in many of these countries. In India, this led to an equity boom and the growth of the new issue market (NIM).

Most studies looking at industrial financing in India have concentrated on the factors which guided the funding activities in the intermediation phase. While understanding the phase of above mentioned transition is crucial to understanding the development of corporate financing in a developing country, there have hardly been any studies which have analysed this transition. Before we provide a backdrop to the financial liberalisation program in India, in the following section we discuss some of the relevant analytical literature on financial sector liberalisation and reforms.

1.3 Financial Sector Reforms: A Survey of Literature

There has been much discussion on the relationship between financial sector growth and economic development in general. Copeland, Goldsmith and McKinnon considered the growing sophistication of the financial sector expressed through both overall growth and the diversity of financial instruments, to be of crucial importance to economic development. On the issue of financial liberalisation, however, there have been divergent positions. The view of financial liberalisation as a major factor pushing faster growth, was influenced by the work of McKinnon (1973, 1991), Shaw (1973), and Fry (1978, 1988). These studies expressed the view that financial liberalisation would permit financial deepening and in the process would tend to promote economic growth. A slightly different view was expressed by Patrick (1966), who suggested that it generally promotes economic growth, but with a lag, as development proceeds. This debate essentially centred around whether the demand-following or the supply-leading characteristics of the financial system dominated in the economy.

By contrast, Dornbush and Reynoso (1989) did not consider financial liberalisation to be a factor of much significance and did not attach any importance to this as a catalyst for growth. Some ‘structuralists’ like Buffie (1984), Taylor (1983), and Wijnberger (1983) have even concluded that financial deepening can result in the reduction of total supply of credit in the economy, and therefore, can reduce economic growth through a reduction in total real investment. These studies suggest that financial liberalisation can have different results depending on the stage of development and the structure of economy.

In the seventies, papers by McKinnon (1973) and Shaw (1973) had brought to light some damaging effects of financial controls on financial deepening and the related impeding effects on economic growth.26 In a variant of the ‘efficient market hypothesis’, these papers argued that deregulated financial markets would guide savers towards higher productivity investments. Financial liberalisation was thus seen as the route to achieving higher levels of domestic savings and investment, as well as bringing about efficient allocation of capital.

Financial intermediaries play a positive role, once the assumption of perfect information is relaxed, as was done by the neo-Keynesians. They challenged the view that financial markets are efficient allocators of capital, and made an argument for greater state intervention in and regulation of such markets. Of course, the question remains as to how well these roles are performed in actual situations of state intervention to correct the problem of imperfections. State’s capacities could also be limited, as the critique of the neo-Keynesians suggests. Governments are corrupt and short-sighted because of their own electoral and political calendars, making government failures as likely or even more likely than market failures.27

It was Keynes28 who proposed the idea of government intervention to create effective demand and further suggested an intermediary status for government to keep the speculative element in check. Subsequently, studies by Copeland (1952), Goldsmith (1969) and McKinnon (1973) confirmed the links of the real sector to the

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financial sector. These ideas were given high priority by many countries in Asia and Africa, which followed a state-intermediated financial system of funding investment during the 1960s to 1980s. Besides, many of these countries which were victims of colonial repression had large foreign ownership and economic control even after political independence. Hence, financial systems in the post-independence phase were highly dependent on foreign banks and financial intermediaries based in western financial centres like London. In most of these countries, including India, the financial system was geared mainly to satisfy the short term requirements of the economy and was largely concentrated in metropolitan cities. This compelled the post-independence governments to drastically alter and reorient the financial system to carry on the process of development. Thus, the colonial stigma, domestic scarcity of capital and the prevalent ideology could be cited as reasons for the interventionist approach to the growth of the financial system (or what McKinnon termed as financial repression) in these economies.

The move to liberalise financial markets was driven by the theory that higher interest rates would deliver higher savings and investment rates, especially in developing economies. However, there is little empirical evidence of a strong relationship between the interest rate and the supply of savings\(^\text{29}\). Nor has it been proven convincingly that financial liberalisation leads to a higher levels of investment. Nevertheless, across the world, the former argument was used to justify policies of financial liberalisation, most prominently in the southern cone of Latin America, Turkey, parts of Africa and East Asia. Some of the analytical roots of this argument, as well as some empirical evidence, are discussed below.

The literature which opposed the financial repression hypothesis and advocated financial liberalisation emphasised certain aspects, while ignoring certain other important implications. The assumption of unidirectional causality of financial development causing economic growth was criticised by Patrick in 1966, who argued that causality runs both ways. His study supported the Shaw-Mckinnon hypothesis that in the early stages of development of a economy, a unidirectional causality can be expressed in the form of a tendency for growing financial intermediation to act as a push for economic growth. But, in the later stages of development, the increasing

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sophistication of financial institutions dominantly reflects demand forces, emanating from the process of growth itself.

The claimed positive link between savings and real interest rates has also generated much criticism. Several studies emphasised the many complex issues which determined this relationship, such as (a) substitution and income effects and their influence on savings, (b) shifts in the ‘composition’ and ‘volume’ of savings, and (c) the existence of formal and informal markets in the economy. Giovannini’s study of Asia-Pacific economies found no concrete evidence to support the idea of a high elasticity of savings with respect to the real interest rate. The same conclusion was derived by various other studies by the World Bank, Leff and Sato, Fry, Hanna, and Barandiaran.

Clearly, relying on the interest rate as the only instrument to influence saving and investment behaviour would therefore be inadequate. A more holistic approach is required. Besides this, there are problems of market failures stemming from dominant presence of firms with monopolistic powers, high tendency to capital flight, systemic failures and contagion effects, all of which are not predicted by theories supporting financial liberalisation.

Highlighting the possibilities of market failure in financial systems, Stiglitz explained the role of information asymmetries, in the event of banks not having perfect information about the creditworthiness of borrowers. The problems of moral hazard and adverse selection could also emerge in such systems. Hence, the hypothesis of financial liberalisation is overtly optimistic and somewhat naive, when considering these larger effects. It paid inadequate attention to prudential, organisational and protective regulation. Another important aspect which needs to be addressed is the structure of industrial investment (the end use of finance) in such liberalised systems.

Some studies by the World Bank on countries which have undertaken financial reforms, provide a listing of possible effects which it can have on 'domestic firms'; i.e., on firms which are not multinational or transnational in outlook and structure of ownership holding. Jaramillo\(^\text{37}\) et. al. conducted a study of the effects of financial liberalisation on firms in Ecuador, which showed a decreased role of bank credits in their sources of finance for investment. It was found that the adjustment process was much more severe for small firms which concentrated on the domestic market. Such firms adjusted to the changing situation by shifting to trade credit, and typically did not take the capital market route for raising funds. But, the larger and older firms got maximum advantage in the liberalised phase in terms of bank credit. Some other effects of liberalisation were: (i) a rise in the cost of capital; (ii) decreasing leverage of small firms as credit was limited due to the problem of information asymmetry, (this also led to credit reallocation to larger and medium firms at the expense of small firms); and (iii) decrease in the capital intensity of firms after liberalisation.

Recent developments in the Southeast Asian economies have brought into question the role of the banking sector as well as the policy of full convertibility of the exchange rate. What was highlighted in the whole crisis was the crucial role of states and of establishing a strong regulatory mechanism to check capital flows across borders, to reduce the seriousness of market failures and cushion the effects of a sudden loss of investor confidence. It has also suggested that the uncontrolled growth of large companies in making international commitments can also become a major factor in the making of financial crisis. This highlights the need to focus on the end use of the finance raised under an unregulated free market.

Another aspect which was not addressed adequately in the theoretical discussion with respect to financial liberalisation relates to political commitment and regulatory strength. Given the corruption and lack of transparency in the operations of the corporate sector which are common in both developing and developed economies, along with technological backwardness and political instability especially in developing countries, it is evident that market operations can seriously impinge on social welfare. In such circumstances, it is being increasingly recognised once again that the "second-

"best" policy is government intervention in the activities that lead to concentration of wealth.

1.3.1 Role of Commercial Banks in Financing Investments

At the macro level, Keynes gave a very prominent role to banks in the financing of investments. He argued that banks were the main suppliers of finance in modern economies. The role of banks in financial intermediation to support growth at the micro-level was discussed in the post-Keynesian literature. Some initial work in this tradition were by Gurley and Shaw (1955), and Goldsmith (1969). These works encouraged credit based systems which gave a prominent role to banks and development financial institutions (DFIs) for investment funding and allocation.

Such intermediated funding activity was found to have a number of advantages in the case of late starters in industrialisation. The advantages of this system include the possibility that a faster growth can be achieved in areas of dynamic comparative advantage, and that industries which have higher social rates of return than their private rates (because of positive externalities) can be allocated more finance accordingly. The system also encourages a longer term perspective for investors than the profit motive approach of the capital-market-based system (CMBS). Thus, as Stiglitz (1988) and Diamond (1984) pointed out banks were seen as screening devices for the allocation of credit or delegated monitors on behalf of the depositors.

This advantage was highlighted by a study by Harm Christian (1992) which analysed the financing of firms in Germany. The study concluded that while the German system avoided credit rationing via banks and DFIs, and instead, used a system of direct subsidies and financing of small firms by small banks, in all the cases the government provided a guarantee for all loans. State subsidies took various forms in Germany like interest rate subsidies, cost reimbursements in structurally weak regions and reimbursement of consultancy activities, etc. The access to such facilities was limited based on size, age and number of employees of companies, but in all these

38 J.M. Keynes, 1939, opcit.
cases, the role of government was relatively higher compared to the United States (US) and the United Kingdom (UK).

Overall, the literature suggested that banks had two advantages. They could act as diligent monitors\(^42\), and, in contrast to the stock market, they allowed for a long-term relationship and commitment.\(^43\) Another factor favouring bank-based systems, is the quality of re-negotiability of bank credits when compared to securities sold in the stock market. The principal role of banks and DFIs in the developing countries was the mobilisation of funds from the household sector which could be channelled into productive investment. The cardinal means of such intermediation were bank deposits, which was the form in which a major portion of the financial savings of the household sector was held. The funds mobilised in this form were disbursed through credit, which was the main source of external finance for industry. Banks and DFIs as intermediaries served four basic functions\(^44\): i) liability-asset transformation i.e., accepting deposits as a liability and converting them into assets such as loans; ii) size transformation i.e., providing large loans on the basis of numerous small deposits; iii) maturity transformation i.e., offering savers alternate forms of deposits according to their liability preferences, while providing borrowers with loans of desired maturities; and iv) risk transformation, i.e., distribution of risk through diversification, which substantially reduces the risk savers would have to bear by lending directly. These are functions which none of the other institutions in the market for funds can provide, even the stock market, which is proposed as an alternative by the neo-liberals.

Needless to say, the relevance of banks varies across time and space. Studies like those by Frankel and Montgomery found that bank financing of the US corporate sector was less than that in the UK, Germany and Japan. US firms met their fund requirements through the issue of securities during the period 1965 to 1979. There was a reversal of this trend in the 1980s, due to a process of restructuring involving the


buy-back of publicly traded shares. Yet, bank financing in the US firms did not increase more by than 30 percent. This was partly related to the failure of the banking system in America, which was linked to corporate bankruptcy and the loss of public confidence in the banking system in the 1980s. On the other hand, Japanese and German banks contributed to asset creation to a much greater extent than the US banks and grew stronger, as fluctuations in corporate investment in those countries have been comparatively less. Cherubini et. al., conducted a study of nine countries which showed an increasing degree of intermediation during 1980 to 1988.

In the recent past, however, the role of banks has been questioned by many studies, which advocate a substitution of bank credit by debentures. These studies support a 'pure' and 'passive' role for banks. The new view was proposed in the studies of Fama which held that banks were not an independent source of net addition to aggregate spending. But, studies by Kashyap et.al. and Romer and Romer provide a role to credit in the monetary transmission process, and attribute to banks and DFIs a role in the transmission of monetary policy. This crucial role of banks as intermediaries is seen to be lost as a result of the structural changes that are taking place under a liberalised financial system in many developing countries.

1.3.2 Role of Stock Market in Financing Investments

One of the most debated choices facing the developing countries today is that of relying on stock markets as opposed to banks, for funding industrial investments. As already discussed in the previous section, there exists no unanimous view on this choice, as the world is divided on the merits and demerits of both systems. Although both banks and stock markets have existed in most advanced countries for many years, the role played by these institutions have varied over time.

Chapter-I

Stock market-based financial systems have been associated with funding activities in the UK since the nineteenth century. But, towards the first half of the twentieth century, stock markets played an increased role in financing industries in the UK.\(^5^0\) The data on the London Stock Exchange (LSE) showed that apart from government debt, railways were the most important activity financed during this period. Further, the role of domestic participants showed a decrease and foreign participation showed an increase in both these categories.\(^5^1\) The significant foreign participation reflected the nature of British colonial activities during that period, wherein investments in activities related to colonial expansion in most of her colonies were channelled through the LSE.

In the first half of the twentieth century, the role of the LSE in raising funds for industries declined and it was in the US that stock markets came to have the greatest relative importance.\(^5^2\) However, by the second half of the twentieth century, even in the US, the role of stock markets declined. A study by Mayer (1988) found from a comparison of various sources of funding in France, Germany, Japan, United States, and the UK that during 1970-85, retained earnings formed the most significant source of funds, and that stock market financing was relatively unimportant.\(^5^3\) It is thus clear that during the initial years of industrialisation the stock market came to prominence in the US and the UK, but with the growing economic power of these countries, finance from this institution was partly replaced by trade credits and retained earnings.

In the later half of the twentieth century (1980s), globalisation and privatisation in Europe, Latin America and Asia led to an outpouring of new issues.\(^5^4\)\(^5^5\) This led to growth in equity markets in the developing countries, which were referred to as "emerging equity markets" by the IFC. The World Bank actively promoted stock market development in the third world countries and encouraged them to open up to

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\(^5^0\) According to Michie (1987), roughly one quarter of capital formation was raised through the London Stock Exchange in 1853; by 1913 it had grown to one third. R. Michie, 1987, "The London and New York Stock Exchanges 1850-1914, London, Allen and Unwin, Page 110.

\(^5^1\) The Government debt decreased from 76 per cent (1853) to 34.8 per cent (1913) and Railways increased its share from 18.5 per cent to 34.8 per cent, but overall the share of foreign sector increased from 8.5 per cent (1853) to 53.2 per cent, see Table 2.4., page 54.


foreign portfolio investments. In many developed countries (excluding the US), where investment of household savings in, and the dependence of firms on, the stock markets for finance is relatively small, a crisis in their stock markets (even due to the opening up to foreign investments) would have no significant macro impact. On the other hand, the implications of such opening would need a detailed study in the case of developing countries, as even small firms in these countries revealed a growing dependence on their stock markets. A 1993 study by UNCTAD showed that new equity issues formed a third of the aggregate gross domestic investment in the Republic of Korea, Thailand, Malaysia and Turkey during the eighties.

There are two roles for the stock market as an intermediary in a financial system. First, as a substitute for banks in financing investments. And second, as a complement to them, serving to enhance the liquidity of investments by providing the opportunity to divest portfolio, and by offering information from insiders to potential investors and creditors through trading. The relative significance of these roles depends on the competitiveness of the stock markets in different countries. In the case of the US, the stock market is highly competitive as a large number of anonymous investors participate.

Levin and Kent (1995) have suggested that the lack of a vibrant stock market leads to a higher debt-equity ratio for firms which in turn leads to higher business for banks, which are in the business of lending. A corollary to this is that the development of the stock market leads to a reduction in the business of banks. Thus, according to them, in the short run, banks and the stock market are not complementary to each other, while in the long run they are. It is during the transitional short run, that a shift in the financing pattern of firms from bank to stock market dependence is experienced. The influence of the stock market was found to be ‘positive’ on both small and large firms. For large firms, it provided an alternative source of finance, and for small firms, it helped ease credit market conditions by lowering the credit demand from big firms during a situation of boom-related overvaluation of shares. This was supported by

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Taggart’s finding that firms are more likely to issue shares rather than debt when the stock market is overvalued.  

Based on a study using a simple Kaleckian investment model conducted on the Dutch manufacturing sector, Ees et al. argued that reliance on the capital market increases primarily during a period of boom. The investment model used allowed for a positive relationship between the level of current profit and investment. The assumption was that as economic conditions deteriorate, given the imperfection of capital markets, adverse selection and moral hazard problems also increase, so that firms have to depend more on internal funds. From the analysis of data relating to nearly 30 years (1951-1987) and five major sectors in manufacturing, the impact of the profit level on the rate of investment was found to be counter-cyclical. This evidence is in line with the financial acceleration model.

Thus the stock market can be seen as providing:

1. a means to transfer funds from lenders to borrowers;
2. a source of finance for large scale investment through mobilisation of savings from several small savers;
3. a means of financing long-term investments with funds provided by individuals, many of whom wish to lend for only a short periods.
4. an evaluation of the financial conditions and future prospects of borrowing firms; and,
5. guidance to business management, as the cost of capital is determined by the price established in secondary market.

The intermediation process in the market-based funding activities varies with the default risk of securities which come out in the market. A market with higher default risk or dominated by high risk issues will be intermediated more than others. The degree of differentiation in intermediation also can be viewed from two different angles. The first one is where investment in the securities market is left to non-banking finance companies like merchant bankers, non-banking financial companies (NBFCs), insurance companies, pension funds and mutual funds. The second is the other extreme, where the banking sector has a dominant role in all aspects of intermediation.

There will be some structural characteristics which are unique to a certain existing system, like, a strong market for long-term fixed rate notes in a system in which institutional investors have importance, and short- or medium-term or floating rate securities in markets where banks dominate.

The intermediation process also depends upon the quality of financial instruments brought out by the financial intermediaries. Unlike in the case of banks where debt dominates, in the stock exchanges both debt (debentures and bonds) and equity instruments are issued. With debt and equity not perfectly substitutable, the variation in debt-equity ratios across firms and industries needs explanation. Factors guiding the decision on source and instruments of financing are: i) financial market development, ii) macroeconomic factors like growth of the economy and inflation trends, iii) tax differences, iv) expectations and structural changes, and finally iv) some firm-specific factors like agency problems, asymmetric information, take-over threats, etc.

In terms of the reduction of transaction cost, search cost and monitoring cost, the stock market can parallel banks as a funding intermediary. However, in terms of effective regulation, government control and security this market intermediary is very weak in the developing countries. The latter weakness of stock markets can lead to the dominance of the speculative motive in the market. This could create conditions which adversely affect investment activities and lead to a loss of confidence.

1.4 Indian Experience of Financial Liberalisation: A Brief Background

As a prelude to a discussion on the development and growth of capital markets in India, this section undertakes a historical analysis of the industrial and financial policies that led up to the liberalisation of the 1990s in India.

1.4.1 Industrial Policy: A Critical Review

The formulation of India’s post-independence industrial policy began with the first Statement of Industrial Policy (SIP) in 1945, which was followed by a restatement in 1948. A comprehensive industrial policy was formulated and adopted in 1956, which underwent four revisions in 1973, 1977, 1980, and 1991, and the most recent revision in 1997. In brief, all the SIPs till 1977 tended to increase restrictions on the private corporate sector, while each of the SIPs since 1980 contributed to a shift away from stringent controls on resource allocation in favour of relatively liberalised policies.
Government control over resource allocation was partly exercised through regulations on the public issues by industrial enterprises in the new issue market (NIM). These regulations, implemented by the office of the Controller of Capital Issues (CCI), involved strict controls on the pricing and timing of issues. Further, companies which used external finance were highly dependent on the Development Financial Institutions (DFIs) for term loans and underwriting facilities. As a result firms were also subject to indirect restrictions on location, etc., since the DFIs were, in their lending and underwriting activities, obliged to fulfil governmental objectives on balanced regional development.

**Industrial Policy Resolution (IPR), 1948**

The IPR of 1948 was the first post-independence official resolution on industrial policy. It classified industries into three categories. First, industries which were reserved exclusively for the public sector; secondly, industries which were controlled and regulated by the government, in which government would participate along with the private sector; and thirdly, those industries which were not mentioned in either of the first two lists and which were left to the private sector.

The first step in the implementation of IPR, 1948 was the introduction of the Bill on Industries (Development and Control), 1949. Among the important provisions of the Bill were those that prescribed that start up of a new firm or expansion of an existing industrial unit could not be done without a license from the government, and that laid down conditions on location, minimum size, and technology. Government was also vested with the full power to investigate any lacunae in the operations of the private sector.

The first list of IPR-1948 consisting of eight industries was expanded by the Industrial (Development and Regulation) Act, 1951 (IDRA-51) to include 38 industries under the classification of “scheduled industries”. Further, securing a licence was made compulsory for establishing a new enterprise, manufacturing a “new article” by an existing firm, “substantial expansion” in capacity by an existing firm, and carrying out business in an area that was previously exempted from the scheduled

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60 During 1964 to 1970, the financial structure of the Indian capital market underwent significant changes with an increasing role for apex development banks (e.g. IDBI) and institutions like the LIC and UTI as coordinating agencies in the NIM. Refer Page 2, Bhatia B., 1976.

61 “Substantial expansion” was interpreted as 10 per cent of the existing capacity, under Clause 3.
list. To regulate foreign exchange utilisation, the Directorate General of Technical Development (DGTD) was set up to evaluate a proposal from the point of view of its import-substitution and export-promotion abilities, technical soundness, the indigenous angle and locational aspects.

**Industrial Policy Resolution (IPR), 1956**

The second IPR was passed in 1956 after the adoption of a "socialistic pattern of society" in India. It too classified industries on similar lines as the earlier policy, and included 28 industries in the public sector list as compared with 9 in 1948. Despite its provisions, a growing concentration of wealth and capital was witnessed, as the large industrial houses took advantage of the loopholes in the licensing policy to garner an undue share of licences and prevent entry by producers from outside the traditional oligopolistic sector. Various committees were set up to review the performance of the industrial policies and the growth of the large houses, and frame policies that would reduce concentration of wealth, help conserve foreign exchange, and redress industrial policy failures. After considering the findings and suggestions of these committees, the government enacted the Monopolies and Restrictive Trade Practice Act (MRTP) in July 1969 and set up the Monopolies Restrictive Trade Practices Commission to look into irregularities regarding growth of large industrial houses in India. The three main objectives of this act were: a) to control concentration of economic power which would be detrimental to public interest through regulation of substantial expansion, merger, take-over, commissioning of new projects and appointment of directors to other firms etc.; b) to control monopolistic practices of dominant or oligopolistic enterprises; and c) to control restrictive trade practices carried out by two or more firms. For the purpose of regulation, large firms were put into two categories i.e., "dominant undertakings" and "monopolistic undertakings". All these discouraged the expansion of large private firms in India.

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62 To mention some, a) Swaminathan committee (1964), b) Monopolies Inquiry Commission (1965), c) Hazari Committee (1966) and, d) Dutt Committee (1967).


64 Defined as those undertaking either by themselves or along with interconnected enterprises, controlled not less than one-third of the total production of goods or services of any description, and also had assets of not less than 10 million rupees.

65 Defined as, enterprises which together with not more than two other enterprises, controlled one half of the total goods or services of any description and whose assets exceed 200 million (20 crores) rupees.
The Industrial Licensing Policy of 1973 (IPR-73)

The first major modification of the IPR was carried out in 1973, to provide the new legal and institutional arrangements necessitated by MRTP Act. The major changes in policy were modification of regulations governing the "core sector" to accommodate the large industries, and redefinition of large industrial groups to attain conformity with the MRTP Act. The "core sector", considered critical for the development of the economy, was opened up for large industrial groups, and branches and subsidiaries of foreign companies. Restrictions were put on investments by private sector in the list of industries reserved for public sector investment.

However, there was confusion regarding the status of many industries. The reservation for "small scale sector" was once again assured by the notification. One of the important regulatory changes made was the amendment to the Foreign Exchange Regulation Act (FERA) 1947, which made dilution of the foreign shareholding in foreign-controlled rupee companies to 40 per cent, a prerequisite for their being eligible for national treatment. However, more industrial sectors were made eligible for foreign investments leading to an overall expansion in the role of FDI in the economy, with restriction on majority ownership.

In 1975, the industrial licensing policy was modified once again to exempt another 21 industries from licensing, subject to conditions like non-SSI status, restriction on imports and not being an MRTP or foreign company etc. Following the recommendation of the report by a study group in 1971, the government also took some new steps to promote the cottage and small and "tiny sector". The list of industries reserved for this category was expanded from 180 to 500. The SIP of 1977 also provided some relaxation of import quotas and quantitative restrictions, and also of compulsory obligations for 100 per cent Export Oriented Units (EOU) for promoting exports. This policy thus led to the expansion of SSIs and shifted emphasis from import-substituting industries to export-promoting ones.

66 Defined as enterprises with investment of not less than 200 million (20 crores) rupees along with interconnected companies. This was less than the Dutt committee classification of 350 (35 crores) million rupees.
67 Defined in 1970 notification as a small-scale or ancillary enterprise having fixed assets in plant and machinery not exceeding 750,000 rupees and 1 million rupees respectively.
68 Tiny sector was a new usage, and comprised of industries with investment in machinery and equipment up to 100,000 rupees which were situated in village and in towns with population of less than 50,000 according to 1971 population census.
The industrial policies till 1980 under the various IPRs can be summarised as initiatives to boost growth of industries under the strict control of the government, through licensing, and controls on capacity, capital flows, and import of technology and machinery in the private sector.

**Industrial Policies Of A Liberalised Era: The 1980s and Early Nineties**

Economic reform in India in the mid-eighties took the form, *inter alia*, of the removal or simplification of controls and regulations in the industrial sector. The first stage involved the expansion of the “Open General License” (OGL) or free import (subject to duty) list and the de-reservation or de-licensing of a number of industries. This phase also witnessed some promotional activities in the capital markets like dividend balancing, reduction in capital gains tax and relaxation of various controls on capital issues.

The second stage was led by policy changes dominated by ‘supply side economics’. These changes were carried out under the Structural Adjustment Program (SAP), and involved a range of fiscal, financial and monetary policies. With respect to the industrial sector, the broad objective of the SAP which started in the late eighties, was to increase the efficiency of manufacturing enterprises by improving productivity and efficiency through liberalisation, privatisation and de-licensing.

**Statement Of Industrial Policy, 1980**

The main objectives of the statement of Industrial Policy (SIP), 1980 were: a) to maximise production through optimum utilisation of existing capacity and by achieving higher productivity; b) to reduce unemployment, and c) to remove regional imbalances through development of backward regions. While the import-substitution approach was continued with, there was a gradual shift towards export promotion.

The 1980 SIP tried to link the small and large industries, unlike the policy of 1977. For the industrialisation of “no industry districts” or backward districts by

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69 Many industries from schedule ‘A’ of the industrial policy which was reserved for the public sector and Schedule ‘B’ for which the capacity expansion and new industries required a lengthy licensing procedure.

70 Removing the difference in dividends given to preference shares and ordinary shares.

71 A detailed discussion is carried out in Chapter II.


“ancillarization”, small scale units and ‘ancillary enterprises’ were redefined. The policy used various strategies for increasing the utilisation of existing industrial capacity, promoted export-oriented units (EOUs) and simplified the procedures that applied to MRTP and FERA companies. There was a relaxation of ceilings on foreign equity holding for foreign-controlled rupee companies (from 40 to 51 percent). These policy changes were aimed at generating higher investment and growth in the private sector. This got reflected in an expansion of the capital base of private industries in India. The promotion of private initiative by the liberalisation of industrial policy triggered direct funding initiatives by the private sector, leading to the growth of the new issue market (NIM).

In the process of liberalisation after 1984, the Open General License (OGL) list was expanded, procedures and conditions for the grant of import and export licenses were relaxed and import quotas were expanded. In 1985, through an initiative known as “broad-banding”, the government allowed greater flexibility in the product mix in the automobile industry, and subsequently applied the same criteria to industries like machinery for chemicals, paper and pulp products, pharmaceuticals, petrochemicals and the fertiliser industry. Some very important changes in the definition of industries were carried out during this period. FERA and MRTP companies were exempted from licensing in twenty-three industries, if the investment was in government specified backward areas. Besides, government also legalised the expansion of productive capacity over licensed capacity for export purposes, to encourage export growth. Computer software and chemical industries were two important industries that got a boost out of such regulatory changes.

The supply side economic principles that were the driving force behind the changes in regulation included the following: the belief that reduced taxes would lead

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74 Ancillary industry is one which has investment of fixed assets in plant and machinery held on ownership terms by issues or by hire purchase not exceeding 1.5 million rupees and engaged in (a) manufacturing of parts or components, bus assembling, tooling of intermediaries, or (b) the rendering of services, and supplying or rendering of 50 per cent of their production or the total services, as the case may be, to other enterprises for production of their articles. The definition applies to all such units except a unit which is a subsidiary of, or owned or controlled by other enterprises.

75 Chapter II has a detailed discussion on the growth of NIM in the 1980s.

76 For example, this permits the private sector automobile (two wheeler) units to produce any motor bike up to a capacity of 350 cc.
to increased production in the private sector; that government tax receipts were unproductive or less productive than tax relief; that a curtailment of the government's socio-economic commitments could be used to compensate tax reliefs; that plan outlays need to be reduced to widen the field for private sector investment; and, finally, that the private sector was more efficient than the public sector. 77 All these provided the backdrop for the changes in taxation, licensing procedures, liberalisation in the financing of enterprises and the broadening of definitions. 78 As the thrust of the new policies was growth based on the private sector with a reduction in the role of the government in various economic spheres, they were criticised as being anti-poor and pro-rich and for leading to a loss of government control over the economy. 79

**Industrial Policy of Late Eighties And Early Nineties**

Further liberalisation was carried out in 1988, when projects having investment in fixed assets up to Rs. 50 crores in centrally declared backward areas, and Rs. 15 crores in other areas, were relieved of the obligation to obtain industrial licenses under the Industries (Development and Regulation) Act (IDRA) in respect of non-MRTP and non-FERA enterprises. This met with critical response from many economists that it would neither help influence the direction of industrial growth nor restrict the growth of monopoly. 80

In May 1990, the asset limit in the definitions of small scale and agro-based industries were raised to Rs. 25 crores of fixed assets in non-backward areas, and Rs. 75 crores in centrally declared backward areas (for new firms). Industrial licensing was nearly abolished with only eight industries being put in the reserved list for the public sector. The second category consisted of eighteen industries (from which nine were withdrawn in 1997) where entry required a license except for SSI enterprises. A third category consisted of 34 priority industries, involving large investments and advanced technology, in which 51 per cent foreign equity investment (FDI) was permitted and 100 per cent allowed in 100 per cent EOU. The terms of technology transfer in these cases were left to pure commercial evaluation and the government had no intervening role, of the kind wielded by the DGTD, which had been abolished. All

these policy changes paved the way for a gradual increase in the levels of access and freedom of private entrepreneurs.

These changes also brought about a change in the role of states, in the direction of providing facilities and attracting investments through investment incentives like subsidies on fixed capital, special incentives, sales tax exemptions, rebate on power, allotment of sites and sheds, rebates on interest charged by DFIs, tax holidays etc. The backward regions were given preference in all these policy initiatives. The FERA, 1977 was completely modified to allow direct investment upto 51% foreign equity and easier import of technology. Barriers to entry into various industries by domestic capital were removed, including the restrictions applicable under the MRTP Act in order to enable them to face foreign competition.

Thus, in brief, the liberalisation of the late eighties and early nineties virtually led to the unregulated operation of the private sector in India. This has generated some concern about the likely economic consequences and effects of these liberalised policies on industrial concentration, employment, regional balance in development, the capability for technological adaptation and upgradation and the growth of indigenous business, etc. Although nearly a decade has passed since the liberalisation of industrial policy has been implemented, there are hardly any studies which have tried to understand the effects of these policy changes on the Indian economy. Further, the impact and influence of all these changed industrial policies on patterns of industrial financing in India have not been analysed. Some of these questions shall be taken up for analysis in this thesis, using the investments trends from the new issue markets.

1.4.2 Financial Policy in India

The dominant core of India’s financial system is the central bank and a wide network of commercial banks (state-owned, private and co-operative) and specialised term-lending institutions. Besides the credit institutions, India has a stock market that is one of the oldest existing stock markets in Asia, dating back to 1858, when the first trades took place in Apollo Street, Bombay (Mumbai). Financial markets in India registered tremendous growth during the years of regulation, in terms of the expansion of the network of banks, development finance institutions and stock exchanges. In the nineties, however, the system

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81 The list of industries mentioned under the Appendix I of the Act was exempted from all restrictions on foreign holding and technology import.
witnessed a degree of diversification with some specialised institutions being established. These new institutions were the Exim Bank, private mutual funds and certain secondary intermediaries like the Discount and Finance House of India (DFHI). This diversification was accompanied by the introduction of new money market instruments like commercial paper and certificates of deposit.

**Indian Financial System**

Between 1951 and 1990, financial intermediation occurred through two broad channels of the financial system, namely, banks and DFIs. The banking sector was organised under the Reserve Bank of India as the central bank, with various commercial, regional and co-operative banks under its control. These commercial banks were further classified based on functional and ownership criteria as private sector, public sector and regional rural banks. Based on RBI regulations, the banks can also be classified as scheduled and non-scheduled banks. While the operations of these banks were always influenced by the monetary and fiscal policies of the government, the controls on the credit generation capacity of banks were enhanced after the nationalisation of thirteen banks in 1969. Yet, the evidence points to a large improvement in the geographical outreach of banks. The population per bank has decreased from 1,10,700 in 1969 to 12,400 in 1994. This has contributed to a spectacular increase in savings mobilisation with deposits rising from 15.3 per cent of the national income in 1969 to 51.8 per cent in 1994. The system of lead banks, which were responsible in each district for the identification of the specific credit needs of that district, proved to be a very effective mechanism to provide credits. The spread of banks and its positive effect on saving generation in India was well highlighted by a study by Athukorala, which identified a positive relationship between real deposit rates and financial savings.

The other major route for financial intermediation, the Financial Institutions (FIs) can be classified into three broad classes based on their organisational structure. The first class consists of the Development Financial Institutions (DFIs) such as, 1) Industrial Finance Corporation of India (IFCI, 1948), 2) Investment Credit and Investment Corporation of India (ICICI, 1955), 3) Industrial Development Bank of

82 Scheduled banks dominated the banking sector. In March 1995, only three of the 288 commercial banks were non-scheduled which accounted for 0.02 per cent of the total bank deposits (See Kunal Sen and Vaidya R. Rajendra, 1997, *The Process of Financial Liberalisation in India*, Oxford University Press, Delhi)
83 Ibid.
84 Ibid., page 42.
India (IDBI, 1964), 4) Shipping Credit and Investment Company of India (SCICI), 5) Industrial Reconstruction Bank of India (IRBI, 1971), 6) Risk Capital and Technology Finance Corporation (RCTC, 1975), 7) Technology Development Corporation of India (TDCI, 1989), 8) Tourism Finance Corporation of India (TFCI, 1989), and 9) Small Industrial Development Bank of India (SIDBI, 1990). These institutions provide only long term loans, and do not seek deposits, which is the difference of these institutions when compared to the banks. The second type of FIs are insurance companies and mutual funds, which include institutions like the Life Insurance Corporation of India (LIC, 1956), General Insurance Corporation of India, (GIC,) Unit Trust of India (UTI, 1964) and various other private mutual funds. The third type of FIs in the Indian financial system are state level institutions like State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

All these institutions are owned by the government and provide assistance to firms through long term loans and underwriting of public issues and subscription to shares and debentures. They also provide deferred payment (bridge loans) facilities for firms to collect funds from other sources. All these institutions helped stimulate activity in NIM in India. Further, when there was a decline in public response to issues by the private corporate sector, the underwriting activity of the FIs led to their subscribing to those issues and enhanced their predominant role in NIM. For example, the UTI had more than 80 per cent of its investments in ordinary shares, preference share and debentures between 1965 to 1974\(^5\). To quote Bhatia (1976):

\begin{quote}
"The reluctance of private investors has also had its effect on financial institutions. Where these institutions are prepared to underwrite new share issues, it is not uncommon to find them left with bulk of these issues on their hands, thus giving rise to the remark that now-a-days underwriters have become undertakers."\(^5^6\)
\end{quote}

The activities of DFIs in NIM also led to an increased role for rights issues, which led to narrowness of the equity market as well. This characteristic of NIM during the late


\(^{56}\) Ibid., page 19.
1960s and 1970s, became a major constraint for new companies in raising funds through this market (Hussain Committee, 1989). 87

During the regulated era, the government decided the priority areas that were to be allocated a specified portion of total funds deployed. Banks and DFIs mobilised public savings through deposits and the issue of bonds in the market, and lent according to these priorities. During these years, both banks and capital markets played an important but distinct role in inter-sectoral capital flows in the economy. Till 1995, banks did not interact directly with capital markets either for raising or deploying of funds (except as collecting agents, or when the capital structure of the banks have been changed). Thus, both the channels substituted each other in terms of instruments used for financing.

1.4.3 Financial Reforms in India: A Brief
Reforms in the financial sector were first recommended by the Committee to Review the Working of the Monetary System in 1985. This committee suggested a movement away from the quantitative controls which were, in its view, distorting the credit market and curbing economic growth. 88 The banking sector was one of the main targets of reform, as this sector was subject to a range of regulations with regard to priority sector investments, interest rates, Cash Reserve Ratio (CRR), and Statutory Liquidity Ratio (SLR). These controls on the banking sector were the means to regulate the cost of capital, liquidity and also availability of funds, during this period.

The actual impetus to the financial sector reform process was given by the high power committee appointed by the government under the chairmanship of M.Narasimham 89, which recommended far-reaching changes in the existing financial system. These included:

1. A complete overhaul of the financial system,
2. The creation of a competitive banking system,
3. The gradual deregulation of interest rates,
4. A sizeable reduction in the proportion of priority sector lending to 20 percent from the existing 40 percent,

5. The re-capitalisation of banks over a period, to attain the standards set by the Bank of International Settlements (BIS),

6. Granting freedom for nationalised banks to raise equity from the market; and

7. A reduction of the SLR from the existing 38.5 per cent to 25 per cent and similar reductions in the Cash Reserve Ratio (CRR).

The progress of the reform process in India has been mixed in terms of results. Reforms that were to be carried out by the Reserve Bank of India (RBI) have taken shape, and the interest rate structure has been liberalised. Interest rate reduction and deregulation were brought about gradually to shift the economy from a regulated high-interest rate regime to one with market-determined rates. The deposit rate ceiling was eased after 1995, and the lending rate was pegged to the prime lending rate (PLR) from 1994-95 onwards. The lending rates increased from 14.1 per cent in 1988 to 16.6 per cent in 1994. The credit-deposit ratio (CDR) over the years showed a decreasing trend from 79.3 per cent in 1971-72 to 55.1 per cent in 1996-97. Thus, deregulation and liberalisation led to an upward movement in the PLR and a decrease in the CDR.\(^\text{90}\) The RBI has also fixed the CRR and SLR ratios in tune with the recommendations of the committee. As of date, the SLR is 25 per cent and CRR is 10 per cent. While the interest rate on commercial banks deposits was raised from 7.25 per cent in 1970-71 to 11 per cent in 1994-95, since then it has been left to the banks’ discretion, with restrictions only on deposits having less than one year maturity.

Opening up of the banking sector for foreign participation was another issue that was addressed. This compelled the government to increase the competence of this sector by automation of all the transactions and reduction in the proportion of non-performing assets (NPAs). The steps taken to achieve this included computerising banking operations, increasing operational efficiency and reducing the cost of transactions. Further, to set a standard and reduce risks in the operations of the banking system, an instrument for checking the financial health of the banks was introduced i.e., the risk-asset ratio. The maximum level of the risk-asset ratio was fixed at 8 per cent, to meet the BIS standards. Banks were given a time-schedule for achieving this ratio and public sector banks were allowed to raise new capital from the market to achieve this standard. NPA provisioning was another measure introduced to

solve the problem of NPA in the banking sector. Besides these restrictions, capital adequacy and income recognition norms were also introduced. The operations of banks have also been made more market-oriented with the introduction of government security auctioning (364 and 91 day Treasury Bills). Another development in the reforms process was the equitisation of commercial banks, with capital raised from the market through new issues.

Although financial liberalisation should remove financial constraints on the household and corporate sectors, the recent experience has been to the contrary. The credit off-take from banks is subdued and prime lending rates (PLR) are sticky downwards as banks have found investment in government securities more lucrative. The large amount of non-performing assets (NPAs) with banks that was a creation of priority sector lending activities, and the general hesitance of banks to operate in a transitional market, led to a decrease in the credit-deposit ratio (CDR) of banks during the nineties.  

As the profitability of many banks dropped due to NPAs, there was a reduction in the credit to the non-food sector. This decrease in non-food credit was largely due to the neglect of small borrowers, whose numbers showed a decrease from 65,862 in 1992 to 56,672 in 1996. Again, the total borrowing of the private corporate sector from banks showed a decreasing trend. This trend was more marked among the small companies, for whom banks' share in total borrowings decreased from 60 per cent in 1990-91 to 42.9 per cent in 1992-93, compared to large companies for whom this share showed hardly any change, moving from 20.4 per cent to 20.8 per cent during the same period. The questions that arise are whether this drop in credit off-take was due to a decrease in the demand for credit from the industrial sector, and if so, what were the factors which were responsible for this decline? Further, what alternative channel was used by these private corporate firms, to raise funds for their investment needs?

92 ibid.
93 The data on the industry-wise borrowing from banks includes medium and large scale industries' credit offtake only. Refer, Ajit and Bangur, 1997, Table 2(13), p. 309.
94 Joshi (1999) at the same conclusion. To quote - "The flip side of banking sector reforms has been the overemphasis on the profits and virtual neglect of the distribution role of the banks. Now, only strong and high net worth companies within the organised sector are capable of raising funds at a considerable lower rate of interest, while the credit disbursal to small borrowers has sharply declined".
The declining trend could be due to two reasons. First, banks could have hesitated to provide credits at random during the slump so as to avoid moral hazard and adverse selection problems. Joshi (1999) found that during the 1990s, banks neglected the small borrowers and wrote-off small accounts, where claims from the Deposit Insurance and Credit Guarantee Corporation of India (DICGC) were received. Further, in the 1990s, a large part of bank investments were in gilded securities. The movement away from social welfare motives that this reflected was a consequence of banking sector reforms and the high priority given to profit generation by banks. It is well known that the cost of managing a large number of small-time borrower accounts is high while the rate of interest on such small accounts is low. The trends in the lending activities of banks suggest that during liberalisation, the small sector was gradually being eased out from the banks’ borrowers profile.

Secondly, against the backdrop of the banking sector’s withdrawal from lending, firms seem to have taken recourse to a source of financing that was more easy to access, and cheaper in cost i.e., NIM. Firms, instead of approaching banks for term-loans and working capital requirements, used the direct channel of public issues. The other reason for the movement towards the capital market could also be the long and cumbersome process of securing a loan approval from banks and DFIs, which was made more arduous by bureaucratic red tape.

The cost of capital also played a crucial role in this apparent shift of the private corporate sector to the primary market. There was an increase in the interest rates on long-term loans from banks and DFIs, associated with the reforms carried out in the banking sector in India. Also, there was a large dip in the cost of equities, calculated using the ratio of dividends to total capital from 1991-92 (Figure 2.4). The interest on debentures showed no sign of such a decreasing trend. This could be attributed to the increase in the price / earnings ratio, following the initial relaxation of debenture-related regulations in the 1980s, and the abolition of the office of the Controller of Capital Issues (CCI) in 1992, which in turn led to a decrease in the cost of equities in comparison to debentures and term loans.

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95 P.N. Joshi, 1999, *opcit.*
97 Although from 1991 to early 1993 this was largely due to the scam in the secondary market.
Further, the reform offered areas of interaction between banks and the capital market, with the former serving as merchant bankers for collection of issues, underwriting of new issues, and investments in stocks in the secondary market (which were still regulated by the RBI at 1.5 per cent of incremental deposits). This is clearly revealed by the non-deposit sources of banks, which gained relative prominence in the 1990s accounting for 5-10 per cent of the total liabilities.

The 1990s also saw an increase in non-banking financial companies (NBFCs), which also have a function similar to that of banks, but whose ownership is largely in private hands. India has gone one step ahead to provide for certain areas of interaction between the capital market and the financial and banking sectors that are not available even in the most developed and stable economies.

Thus, banks' role as an intermediary between savers and borrowers has been reduced by giving the private corporate sector direct access to these savers (household sector). The pick up in activities in the capital market in the eighties and early nineties, thus, has led to a process of 'disintermediation' in the Indian financial system.

1.5 Conclusion

The theories and studies in the field of corporate financing highlight the importance of the capital structure decision of a firm and the importance of debt and equity for fulfilling its various strategies. They establish that funding a project is not just a question of available sources alone, but a strategy about which among the available sources to choose from, to mitigate the existing conflicts in a firm. However, these theories and studies on corporate financing strategies are more relevant and appropriate for the developed countries, where both the debt and equity markets co-existed.

The trends in the financing of firms in the developed countries show that the relative significance of external sources of funds has decreased over the years, since the early industrialisation and colonial periods. This trend was clear in the case of the US and the UK (two dominant economies with strong stock markets), where both banks and stock markets operated simultaneously. It was seen that towards the second half of the twentieth century, the funding activities of the private corporate sector in these countries largely

98 Investment by banks in capital market is prevented under the Glass-Steagall Act of 1934 in Germany, Japan, and UK, in USA, and hence are not prevalent in these countries.

concentrated on internal funds (retained earnings), suggesting a relatively higher yield in these countries. Thus, it was hypothesised that the role of external capital is higher in the initial years of industrialisation in any country, to promote innovation and to provide seed capital.\textsuperscript{100} With an increase in the reputation (good will) and with the growth of firms, a trend towards adopting a clear "pecking order" in the choice of sources of financing is seen, with equity (stock market) being given the last position.\textsuperscript{101} Most of the studies reflect these broad trends in their conclusions, though at firm-level, a lot of debate has taken place regarding the use of debt and equity and the relevance of these instruments for settling conflicting interests between managers and shareholders, as well as between debt holders and equity holders.

It is evident from a survey of the literature on corporate financing strategies that most of the theories fail to examine the choice of financing in an economy ridden with scarcity of capital, as is the case with developing countries. A firm operating under these conditions is always on the look out for relatively cheaper and easier sources of financing. This rush for funds is more prominent in economies with a large number of small firms, as is prevalent in India. Another very important characteristic of the capital market in a developing economy is the existence of asymmetric information and an underdeveloped financial system. With a large concentration of small firms (with higher dependence on external capital), the uncertainty in the financial system caused by the speculative motive can also prove to be detrimental.

Therefore, the usefulness of the literature for small firms operating in domestic capital markets with small margins (yield), for whom survival is more important than dealing with 'conflicting interests', becomes questionable. It was in the later half of the twentieth century, with the gradual decrease in grants and aid, that the Bretton Woods group of institutions focused on foreign investment flows as an alternative to encourage investments in developing countries and as a solution to internal capital scarcity. Thus, foreign direct investments (FDI) followed by portfolio investments promoted the equity markets in these countries. These efforts were largely aided by the International Monetary Fund (IMF), which replaced the earlier mode of crisis management with the so-called

\textsuperscript{100} Hypothesised in the context of the large growth of equity market in developing countries by Ajit Singh (1992).
\textsuperscript{101} A traditional view expressed by Donaldson (1961), Myers (1984, 1985) and Fazzari, Hubbard and Peterson(1988)
Structural Adjustment Programs (SAPs), which included liberalisation of the financial markets as one of its conditions. These institutions highlighted the inefficiency of DFIs and banks and the subsidies provided to various weak sectors in an economy. Further, they called for a restructuring of the financial system in the direction of making them more "voluntary", fiscally neutral, and to bring them as far as possible under private ownership.102

Liberalisation in India initially involved trade liberalisation and the de-licensing of a large number of industries. Subsequent changes focused on fiscal restructuring, banking sector reforms, and liberalisation of the capital market. This led to a change from a credit-based system to a capital market-based system, leading to a change in the funding of capital formation, with even the municipal corporations raising money from the new issue market.103 These changes were spurred by the decrease in budgetary support from the central and state governments.104 Although India was cautious to avoid full convertibility, the country liberalised its domestic capital markets substantially in 1992. This led to a flooding of private corporate companies into the new issue market.

As a result, the domestic capital market has come to play an important role in the financial system. The 1990s seem to be a transition phase in the industrial financing activities in India, with banks' role as an intermediary between savers and borrowers being reduced and the private corporate sector gaining direct access to the savers (household sector).105 The new issue market rose to prominence as a substitute for bank and DFI finance during this transition phase. This process of 'disintermediation' has serious implications for industrial development through its impact on industrial financing.

Thus, understanding the structure of this changing pattern of industrial financing becomes crucially relevant and significant. There are a number of questions

102 To Quote WIDER, 1990, p.6:
"The need to attract capital in non-debt creating forms is only one reason, and not the most important reason, why developing countries should wish to foster their emerging equity market. Equity markets are a vital part of economic development...they encourage savings, help channel savings into productive investments and encourage entrepreneurs to improve the efficiency of investments".

This report puts growth of equity markets for domestic resource mobilisation reasons as well as for tapping foreign savings and know-how on market organisation and technology".

103 The Bangalore Municipality Corporation raised Rs. 125 crores from private financial institutions (privately placed) and The Ahmedabad Municipality Corporation raised Rs. 100 crores from private financial institutions and citizens of India.

104 The central government’s support to municipalities dropped by 20 per cent over the last 10 years. Dilip Maitra, 1999, "Here comes the Muni(ficent) Bonds", Business Today, Vol. 8, no. 8, New Delhi.

105 The household sector is one of the most important sources of savings in India. Reserve Bank of India, "Report of the Committee to Review the Working of the Monetary System", (Chakravarty Committee), Bombay, 1985.
that arise in this context. What is the dependence of Indian firms on external sources of funds and on the new issue market in particular? Is the capital market boom of the nineties, brought about by this transformation of the roles of various channels of financing, sustainable? Does an emerging equity market cause a structural transformation in the patterns of investments? If so, what is the nature of such a transformation? Answers to these questions would help assess whether the growth of NIM in the wake of the liberalisation of the capital market in India, helps the industrialisation process. To answer these questions, this thesis proposes to undertake an analysis of changes in the structure of NIM from 1989 to 1995.