Abstract

In the new milieu of financial reforms in India, market forces increasingly govern the allocation of funds and this has implications for the availability, cost and quantum of funds, which *ceteris paribus* will enable the corporate sector to make an optimum combination of sources of funds for industrial investment. However, in recent times, the financial liberalization argument is criticized by certain micro economic arguments based on market failures and information asymmetries in financial markets. It is argued that in reality, information failures in loan markets and the consequent credit rationing may occur between the buyers and suppliers of productive capital.

This new literature on corporate finance has emphasized the cost disadvantages of external finance due to asymmetric information. Because, in imperfect financial markets with asymmetric information, external funds are more expensive than internal funds and firms have to follow a hierarchy in which cheaper funds are preferable to more expensive ones, and internal funds are the most preferred ones. This literature raises certain issues to be discussed in the context of financial liberalisation: (1) Have the expected benefits of the liberalisation and promotion of stock market and banking sector translated in to better financing choices at firm level? (2) What is the influence of exogenous financial sector liberalisation on firm level capital structure? (3) How does the financing pattern relate to investment of firms? The present study empirically examines these aspects using firm level data for a sample of 2269 manufacturing firms in the Indian private corporate sector.

Against the background of policy changes in the financial sector, we have analysed the trends and patterns of corporate finance at the aggregate level in the pre and post liberalisation period. One of the most striking aspects of trends in sources of funds for private corporate sector is the increasing dependence of firms on internal funds rather than external funds. From the analysis of debt ratios for size categories, it is not wrong to conclude that small firms are credit constrained in the financial liberalization period. However, given the increase in debt and its variations among different size groups it is our interest to study about various determinants of capital structure of firms, specifically the impact of financial liberalisation on capital structure of firms.

Analysis of panel data using fixed effects model give results, which reveal the influence of asymmetric information and the presence of adverse selection problem in the choice of debt structure of firms. It implies that the attempts to develop financial markets have not produced any economy wide efficiency since small and young firms have not increased their debt levels. The study showed that though financial liberalisation had a
positive impact on capital structure, it was mainly concentrated in large and export-oriented firms. It is seen that, the export oriented and large firms are able to enjoy more debt levels owing to their good and transparent management. This makes it cheaper for such firms to raise funds through debt (borrowings). This result supports the view that when asymmetric information prevails it prevents the benefit of deregulation of financial markets to be enjoyed by all firms. What implications do these results have for corporate investment? In order to understand this, we try to empirically examine the factors affecting investment of firms in the private corporate manufacturing sector in relation to the financing pattern.

By estimating an augmented accelerator model of investment, the study found that small firms are facing financial market imperfections in the form of liquidity constraints since it is seen that credit constraints were not eliminated or relaxed for these firms. This is evident from the fact that the prominence of cash flow variable has increased for small firms in the post liberalisation period. This implies that financial liberalisation has not improved the access to external finance for small firms. However, one surprising result is the positive and significant coefficient of debt-to-capital ratio for large firms irrespective of the financial liberalisation effect. From further enquiry we found that the positive and significant impact of debt on investment for large firms has changed once we estimate the model for large firms belongs to other categories based on group and export orientation. It is seen that the positive and significant impact of debt for large firms does not hold for large non-group and non-exporting firms. On the other hand, the positive effect of debt remains the same for large group and exporting firms. This implies that being in a group or having export orientation helped them to access more resources from financial markets.

It would be useful to recall that the underlying factor for firm financing is found to be information asymmetry, more specifically the operation of moral hazard and adverse selection. In such a situation one may argue that relative cost principle is not in operation even after financial reforms. In the context of the need to augment resources available to corporate sector it implies that there is a need for greater role of the state to intervene in the financial markets in terms of evolving suitable accounting standards, regulation on insider trading, strengthening fraud laws, and improving provisions for investors’ protection. It should be recognized that the legal, informational, and incentive frameworks need reform. Such reforms will also involve a much greater private role in the banking sector and, correspondingly will require much stronger regulation and supervision to limit moral hazard.