INTRODUCTION

CHAPTER - 1

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Chapter - 1
Introduction

Finance is the life blood of modern economy. Financial institutions, instruments and markets act as the circulatory system to diffuse finance into the entire body of the economy, making possible the coherent synergy among the many units of activity. The literature on finance since the early 19th century focused its interrelationship with economics. It was observed that, “an immature financial system is in itself an obstacle to economic progress” (Gurley and Shaw, 1968). Economists like Joseph Schumpeter (1934), Raymond W. Goldsmith (1958), John G. Gurley and Edward S. Shaw (1967), James Tobin (1971), Ronald I. McKinnon (1973), George Rosen (1976) and James C. Van Horne (1978) have stressed the importance of financial development on economic growth.

The efficacy of the financial system determines an efficient dispersion of saving among investment opportunities and thereby the rate of growth of output in an economy. In the course of economic development, countries experienced more rapid growth in financial assets than national product. In the US, it was only about one-half of the national wealth in 1880s, increased to 4.5 in 1967. In Japan, the ratio of financial assets to real wealth rose from 10 percent in 1885 to over 150 percent in the later half of 1960s. In Soviet Union, the ratio moved up from 10 percent in 1928 to 35 percent during the same period. In still more developed countries during the second half of 1960s, it was 80-100 percent in France and W.Germany, over 200 percent in Switzerland and 215 percent in the UK.

In India, the development of financial system can be described in three different phases - (i) phase of transition: 1950 - 60, (ii) phase of expansion and diversification: 1970-1985, and (iii) phase of liberalization since 1980. Financial strengthening, geographical expansion, financial efficiency and product diversification have taken place in the first two phases. As a result public banks accounted for about 88% of all bank
branches and provided 85% of all bank credits. A particularly important aspect of Indian financial market policies during this period was the use of credit controls in the form of pre-emption of bank resources, directed credit and administered interest rates. The Cash Reserve Ratio (CRR) in the 1960s and 70s was around 5% grew up to its legal upper limit of 15% in 1991. The Statutory Liquidity Ratio (SLR) rose from 25% in 1970 to 38.5% in 1991, just below the upper limit of 40%. Of the remaining resources, there were directed credit like priority sector lending, export credit, food credit, and other informal and formal pre-emptions. According to some estimates, "close to 75% of the total loan capacity of the Indian banking industry was in some way or another under control of the government". As a result Indian corporate sector was confronted with the problems of access to external finance and higher costs of finance which with deleterious impact on investment.

Financial liberalization began in India by lifting the ceiling on lending rates in 1988 that gained momentum since 1991. A number of reform proposals relating to financial sector, stock exchanges, mutual funds, public sector and foreign investments were announced in the Union Budget for 1991-92. A committee under the chairmanship of Shri. M. Narasimham was appointed in August 1991 to look into all aspects of the financial system. Parliament passed the Securities and Exchange Board of India Bill (SEBI) on April 4, 1992. Reputed foreign investors (FIs) were allowed to invest in Indian capital market in 1992-93. Investment norms for NRIs liberalized, Indian companies were permitted to access international capital markets through Euro equity issues. Over-the-Counter Exchange of India (OTCEI) and the National Stock Exchange of India (NSE) commenced operations with nation-wide stock trading and electronic display, clearing and settlement facilities. All mutual funds including private were allowed to apply for firm allotment in public issues. These are some of the important reform measures. As a result of these, external finance has become an attractive source of finance to the Indian business community.
The empirical evidence on financial sector reform and its impacts on resource allocation in India are somewhat mixed and inconclusive in nature – Athey and Laumas (1994), Huisman and Hermes (1997), Ansari, Joseph, Nitsure and Sabnavis (2002), Athukorala and Sen (2002), Seema Saggar (2005). In this background we make an attempt to analyse the impacts of capital market reforms on the investment behaviour of the private corporate sector.

The Research Problem

The private corporate sector has been playing an important role in the industrial development of India since independence. At the same time the financial sector which acts as facilitator for growth was overregulated. Credit control and administrative interest rate were the two most important regulations which had its impact on the availability of finance at a reasonable rate. So also capital market was overregulated. Before the eighties, the most important component of gross resource mobilization by the Indian private corporate sector was corporate savings. Its reliance on external sources was limited. It was observed that internal savings constituted 64.2 percent on the average in gross resources mobilized by the corporate sector in India during the period 1962-63 to 1975-76.

It is in this background that the Government of India adopted radical change in financial sector policies as part of the Structural Adjustment Programme and economic reforms. This was to enable the financial system to act as an essential conduit for optimum allocation of resources. This can have much impact upon the corporate investment and financing pattern in the post liberalization period. In this context a study on the corporate investment and financing pattern assumes significance.
Objectives
The specific objectives of the study are;

1. to examine the nature of capital market reforms in India
2. to examine the structure and growth of capital market
3. to examine the corporate investment and financing pattern at the aggregate level with the RBI data
4. to analyse the investment behaviour at the firm level and
5. to analyse the financing pattern at the firm level.

Hypothesis
Since 1991, the Government of India liberalized the capital market as part of extensive liberalization programmes. This was to stimulate economic growth as the measures can augment savings and investment. Such policies on the one hand will lead to more efficiency and profitability of the corporate sector and on the other it will lead to more investment as cost of external capital is expected to decline and become more accessible. In this context, we have formulated the hypothesis that the capital market reforms in India since the early 1990s have not;

(i) increased efficiency and profitability of the corporate sector,
(ii) led to the decline in cost and availability of capital,
(iii) promoted investment in the corporate sector.

Methodology
Our study focused to quantify the changes in the pattern of investment and financing of the private corporate sector in the light of capital market reforms since 1991. First, an analysis of RBI data in respect of large Non-Government Non-Financial (NGNF) public limited companies (each with paid-up capital of Rs. 1 Crore and above) for varied sets of samples (ranging from 500 to 997) over the period 1983 to 2003 was done. RBI data was obtained from the combined balance sheet data of the companies
published in the RBI Bulletin various issues from 1984 to 2004. This was followed by the
analysis of a uniform set of 150 companies for the period 1983 to 2003.

**Sample size & Data source:** - We have selected 150 Non-Government Non-Financial
(NGNF) Public Limited Companies incorporated before 1980. These companies were
selected from a total of 1605 such companies in a random basis from the Prowess data
base. The catalog of these companies was synchronized with a current list to avoid the
changes in its name, merger and acquisitions. The balance sheet and profit and loss
account data was obtained from Bombay Stock Exchange Official Directory (BSCOD).
The BSEOD data for the period 1983-1999 for most of the companies and the annual
accounts of companies published thereafter have been brought together to obtain the data
base of the same set of 150 NGNF Public Limited Companies for the period 1983-2003.
In addition to the above sources, data of the Department of Company Affairs, CSO, NSE,
MOSPI website and SEBI were used.

**Analysis:** - The RBI data was analysed in an aggregate level. The analysis of sample data
has been designed at three stages. At first, an aggregate level analysis of all the 150
companies has been done. Secondly, its group (industry-wise and size-wise) characteristics were observed. Thirdly, the firm level analysis was applied. The Industry-
wise classification is based on the company classification of BSE. This is to avoid changes in the allocation of companies among different industry groups as the principal commodity changes over the period 1983-2003. The RBI pattern was pursued for the size-wise grouping. The temporal dimensions of the study include overall (1983-2003), pre-reform (1983-1991) and post-reform (1992-2003) periods.

**Tools of Analysis:** - For the purpose apart from working out the compound growth rate a
number of financial ratios and financial management ratios were worked out.
Correlation and Stepwise Multiple regression methods were also used. The regression
method was adopted for examining the determinants of investment.
Review of Literature

Theoretical Literature

The connection between savings and finance is of a round-about nature. The essay on 'Finance' by Robinson (1952) explains how the supply of saving is related to the supply of finance and investment. It points out that the distribution of saving in the long run has a cumulative influence upon the supply of finance, and so, indirectly upon the rate of investment. The factors influencing the supply of finance have been classified into two: the state of expectations and the legal – institutional arrangements and the habit of lenders. But on the question as to whether entrepreneurship or finance first, the study answers that "where enterprise leads finance follows". Thus capital accumulation takes place when the level of prospective profits and the degree of confidence are high.

Gurley and Shaw (1955) in the article 'Financial Aspects of Economic Development', points out that, "development involves finance as well as goods". Development implies as cause or effect, change in market prices of financial claims and in other terms of trading in loanable funds. The study reviews briefly the financial manifestations of income generation, spending and saving, investment and the accumulation of wealth. In their view, "Economic Development is retarded if only self-finance and direct finance are accessible, if financial intermediaries do not evolve".

Gurley and Shaw (1960) on 'Rudimentary Finance' underlined the role and importance of financial assets in economic growth. The efficacy of the financial system determines an efficient dispersion of saving among investment opportunities and thereby the rate of growth of output in an economy. The basic task of the financial system is to stimulate saving and to allocate it to efficient uses. According to the authors, "an immature financial system is in itself an obstacle to economic progress". The financial

1 Joan Robinson, 'Finance', given in L.C. Gupta (ed), 'Readings in Industrial Finance', (1976), The Macmillan Company of India Ltd, Delhi
system of the rudimentary economy makes no attempt to stimulate private saving either by offering different kinds of financial assets or by allowing an explicit rate of interest on financial assets. As a result the propensity to save and the rate of growth in capital will be relatively low in such economies.

Goldsmith (1965) described the two basic functions of the capital market in an economy: first the allocation of a period’s current saving among users and uses, second, facilitates the transfer of existing assets among individual economic units, sectors and countries. In his words, “financial institutions are those whose assets are predominantly financial and whose liabilities are in general liquid assets by the creditors, while ultimate economic units are those their net worth can not under present legal arrangements become the property of another economic unit”. This essay on the ‘Scope and Function of the Capital Market in the American Economy’ provides a good conceptual and theoretical base on capital market.

Hall and Jorgenson (1967) have studied the relationship between tax policy and investment expenditures using the neoclassical theory of optimal capital accumulation in ‘Tax Policy and Investment Behavior’. The cost to the business firm employing fixed assets depends on the rate of return, the price of investment goods and the tax treatment of business income. The study observed that tax policy is highly effective in changing the level and timing of investment expenditures in the U.S economy. In addition, the tax policy has had important effects on the composition of investment. The liberalization of depreciation rules in 1954, investment tax credit and depreciation guidelines of 1962 caused substantial effects on investment. Using econometric model, for manufacturing and non-farm non-manufacturing equipment and structures for the periods 1931-41 and 1950-63 investment functions were constructed in this study.

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Gurley and Shaw⁶ (1967), in their ‘Financial Structure and Economic Development’, analysed the relationship between economic development, growth in financial assets and national product. Countries that are poor in income per capita have very low ratios of financial to real wealth. In the second half of 1960’s the ratio was 10-15 percent in Afghanistan and Ethiopia, 30-60 percent in Argentina, Brazil, Mexico, Korea, India etc. and 80-100 percent in France, Israel, W.Germany while in Japan it was 150 percent, Soviet Union 35 percent, Switzerland over 200 percent and UK 215 percent. Thus, financial growth in excess of real growth is a common phenomenon around the world. They further points out that “self-finance via inflation shrinks the real stock of financial assets, real flow of funds through financial markets, and real size of financial institutions. Inflation taxes the financial process”.

Jorgenson and Siebert⁷ (1968), compares alternative theories of investment behavior in their study on ‘A Comparison of Alternative Theories of Investment Behavior’, to explain the investment activity of corporations. This study concentrate on time series data for a representative sample of firms selected from the ‘Fortune’ Directory of the 500 largest U.S. industrial corporations for 1962 and tested each of the alternative theories of the demand for capital. The principal conclusion of the study is that the neoclassical theory of investment behavior is superior to theories based on capacity utilization or profit expectations and that these theories are superior to a theory based on internal funds available for investment.

The questions as to; how financial structure changes as economies grow? Does finance exert a causal influence on economic growth? Does the mixture of market intermediaries functioning in an economy influence economic development? In a study

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by Raymond W. Goldsmith⁸ (1969) on ‘Financial Structure and Development’ observed that, banks become larger relative to national output as countries develop. Non bank financial intermediaries and stock markets grow relative to banks as countries expand economically. On causal relationship, he observed a positive correlation between financial development and the level of economic activity in thirty-five countries prior to 1964. The operations of a mixture of market intermediaries and economic development in Germany and U.K, produced illuminating insights on the relationship between financial structure and economic growth.

In the study, ‘Investment and Growth’, Scott⁹(1976) gives a broad definition to investment including expenditure on new machinery and vehicles, buildings, and construction, increases in stocks of goods, research and development, and substantial fractions of expenditure on marketing, planning and the education, health of people. Investment, by this definition will cover all activities associated with growth. In this context he has given more attention to “how to describe and analyze a process of change’. The fundamental idea of investment and capital he put forward was as an agent of change. Moreover, he argues that so long as investment is decreasing in the long-run, re-allocation is occurring. It is not a once-and-for-all source of increase in output, but a continuing process and indeed, the principal source of growth in many countries.

William Diamond¹⁰ (1976) in this essay ‘The Process of Investment’ brings out that the availability of finance is closely linked to a host of factors, all of which together determine the rate of productive investment. The recommendation of the Indian Committee on Finance about the ‘economic climate’ for investment has been mentioned in this. That is, private investment will come forth only if the expectation of compensation for the risks undertaken is reasonable. Investment are coloured not only by

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the economic factors of demand and costs but by various political, social and psychological elements that make up the environment one has to function. It stresses the need for legal codes and practices and safeguards that inspires confidence of institutions and individuals.

Improvements in the financial intermediation process are a pre-condition of economic growth. Vicente Galbis\(^{11}\) (1977) study on ‘Financial Intermediation and Economic Growth in Less-Developed Countries: A Theoretical approach’, shows that high (equilibrium) real interest rates are growth promoting. A two sector model (one is the backward, and the other is modern) provides efficiency aspects in the allocative mechanisms of savings and investment when the technological conditions in the two sectors are different. Similarly, savings, investment and financial intermediation are also explained in the model. The study concludes that, improvements in the process of financial intermediation which are brought about by higher real interest rates yields dramatic acceleration in the overall rate of economic growth.

How financial infrastructure affects both the economy’s financial architecture and the process of real capital formation? Bossone, Mahajan, and Zahir\(^{12}\) (2003) investigates this in their work on ‘Financial Infrastructure, Group Interests and Capital Accumulation: Theory, Evidence and Policy’. It shows that a more developed financial infrastructure promotes the growth of financial markets, reduces the role of traditional banking activities, enables investors to make more investment decisions, and leads to more knowledge-intensive capital accumulation. The model presented in this study suggests that the development of financial infrastructure plays a key role in promoting economic development.


General Literature

The study of George Rosen\(^{13}\)(1958) on 'Capital Markets and the Industrialization of Underdeveloped Economies', focuses upon the flow of finance in UDCs. The major problem is to increase the level of savings and to channel those savings into investments. It observed that in the early period, the indigenous industrial sector would be largely self-financed; the investment would be very risky; and the appeal of this type of investment to most investors would be slight. It concludes by explaining the role of the government in this economy. "In a development period the government, by its expenditures and by its supply of social overhead, makes industrial investment more profitable and competitive with agriculture. It can decrease the speculative portion of the rate of return in agriculture and thus divert investment to industry".

Patrick\(^{14}\)(1966) explains the instances of "demand following" and "supply leading" phenomena in the work 'Financial Development and Economic Growth in Underdeveloped Countries'. In the demand following phenomenon, the creation of modern financial institutions, instruments, and services are in response to the demand for these services. In "supply-leading" phenomenon the creation of these factors are in advance of the demand for them. The transfer of resources from traditional sectors to modern sectors and to promote an entrepreneurial response is the two functions of this. The latter provides an opportunity to induce real growth by financial means thus likely to play a more significant role at the beginning of the growth process than later.

Rungta\(^{15}\)(1970) on the 'Trends in Corporate Financing in India, 1851-1900', describes how Joint Stock Companies between 1850 and 1870 changed their ideas about the capital structure, with regard to; the nominal value of ordinary shares, methods of


\(^{15}\) Radhe Shyam Rungta, 'Trends in Corporate Financing in India, 1851-1900', Given in L.C.Gupta (ed)
raising loan capital and its relationship with the equity capital. The paper reveals that the shares of usual denominations during the 1850’s was of Rs. 5000, and Rs. 2500 which are taken up by wealthy merchants, rulers of Indian states and landlords. But as the demand for capital grow and the social composition of the investors change, the face value came down. In the 1870’s and 80’s shares of the value of Rs. 1000, Rs.500, Rs.250 and Rs.100 were issued. In the 1890’s shares of one rupee were also issued by gold mining companies. The essay also describes how the policies towards depreciation, dividends are reserves were evolved.

Takeuchi (1970)\textsuperscript{16} describes the unique character of the banking system in financing private industrial investment in Japan. The study on ‘The Role of Banks in Japan’s Economic Growth’, mentioned the factors responsible for the rapid economic growth led by capital investment in the 1960’s. During this period the method by which Japanese enterprises raise funds has two features. One was that the low dependence on internal finance and other, the borrowing from banks has a relatively large share in the volume of funds raised from outside sources. The study also explains the reasons why the capital market remains underdeveloped in Japan.

How industrial investment is financed in five developed economies – in France, Japan, W.Germany, the UK and USA? The study of Carrington and Edwards (1979)\textsuperscript{17} on ‘Financing Industrial Investment’, throws light into this aspect. In France during the period 1970-73, the non-financial corporate and quasi-corporate enterprises raised much more in the financial markets. In Japan during 1960-65, the industry had most of the funds from borrowing. In W.Germany, it receive the higher part of loans and advances from financial intermediaries and insurance institutions. In U.K, during 1970-74, the Medium and long-term loans was the largest source of potentially productive investment

\textsuperscript{16} Ichiro Takeuchi, ‘The Role of Banks in Japan’s Economic Growth’, given in L.C. Gupta (ed)...

capital for enterprises. In USA, the funds for non-farm, non-financial corporate business for the period 1963-73 was from external sources.

Panda and Sahu 18 (1985) in their study on ‘Corporate Sector and Institutional Finance in India’ analysed the reasons for the business failures in Indian Corporate sector. They analyzed the sectors, the industry group, and its paid-up capital where majority of failures occurred. It concludes that the failure was greater in processing and manufacturing sector than in others. Moreover, failures were more in the case of smaller companies falling in the size group with below Rs.1 lakh of paid-up capital. While correlating the company liquidation with some of the national economic indicators, it found that there was high degree of negative correlation between GNP and company liquidation. Reasons for the collapse of these business firms centre mainly on tighter liquidity position, working capital, high rate of interest and management deficiencies.

In ‘Financial Development and Economic Growth; International Evidence’, (1986) Woo S. Jung 19 investigates the relationship between financial development and economic growth as mentioned by Patrick. 20 It inspects the causality and temporal behavior of 56 countries. It observed that LDCs have a supply-leading causality patterns than a demand following; thus emphasized the importance of financial development in LDCs. On temporal causality patterns, there seemed to be a mixed result. Considering currency ratio as a measure of financial development, LDCs are characterized by the causal direction from financial to economic development, and DCs in the reverse direction. The two alternative proxies of financial development employed in this study are; currency ratio and monetization variable- the ratio of M2 to nominal GNP.

20 Hugh, T. Patrick, op. cit
In the study, ‘Contribution of Financial Market in Economic Growth: An Indian Experience’, Kapil Dev Sharma describes three phases in the development of Indian financial system; (i) phase of transition: 1950 – 60, (ii) phase of expansion and diversification: 1970-1985, and (iii) phase of liberalization since 1985. The first marked the strengthening of the banking system. Geographical expansion and functional diversification has taken place in the second phase. In the third phase a process of consolidation began. In the context of the experience of the developed as well as developing countries in recent years, he argues that there should be a sound macro economic policy to maintain financial stability in India.

Information and incentive problems affect investment in the Japanese capital market, according to Hoshi, Kashyap and Scharfstein in their study on ‘Corporate Structure, Liquidity, and Investment: Evidence from Japanese Groups’. They provide evidence by grouping Japanese firms into two sets; the first set has close financial ties with large Japanese banks and the other set of firms has weaker link to a main bank. The study observed that investment is more sensitive to liquidity for the second set of firms. Using regression equations, measures of liquidity, Tobin’s q and lagged production as regressors, it observed that liquidity continues to be more important for independent firms. The investment regression results showed that the closer a firm moves to the group banks, the more easily a firm can attract funds to finance investment projects.

The study on ‘Financial Intermediaries and Industrial Development’ by Saghir Ahmad Ansari stressed the role of specialized financial institutions in meeting the term requirements of the industrial sector of the Indian Economy. It looks into the working and operations of mainly three institutions – IDBI, ICICI, and SFCs for meeting the term

23 Saghir Ahmad Ansari, ‘Financial Intermediaries and Industrial Development’, APH Publishing Corporation, New Delhi
requirements of the industrial sector. It used secondary data predominantly the publications of RBI, IDBI and ICICI. The main tool used in the study was trend analysis for the period 1970-90. The study observed the dominance of All India Financial Institutions over State level financial institutions in industrial financing.

The study of Roubini and Sala-i-Martin\(^2\)\(^4\) (1992) on ‘Financial repression and economic growth’ addresses the questions like; what is the role of financial development in the process of economic growth? Is financial repression harmful to growth? The study showed that, various measures of financial repression affect growth negatively and inflation rates and growth are negatively related. The econometric evidence for 98 countries during the 1969-85 period pointed out that high degree of financial repression will witness higher rates of inflation, thus leads to negative real interest rates, high required reserve ratios and choice of a high inflation tax. The empirical evidence of the study is consistent with the theoretical model which can be summarized as, “controlling for other determinants of growth, a high degree of financial underdevelopment and/or financial repression will lead to lower economic growth”.

James E. Hodder and Adrian E. Tschoegl\(^2\)\(^5\)(1993) in their study on ‘Corporate Finance in Japan’, focuses the issue of why Japanese financing and investment practices appear different from the US firms. While comparing Japan and US manufacturing corporations during the period 1980-90, it observed that, as the government relaxed restrictions during 1980’s on offshore funding, bond floatation, and commercial paper issuance, Japanese firms progressively shifted toward market funding sources from short-term debt and trade payables. The study concluded with the observation that much of corporate finance in Japan revolved around the main bank relationship.


Marco Pagano\textsuperscript{26} (1993) in an overview on ‘Financial markets and growth; An overview’, covered the theoretical and empirical observations in the early 1970’s like; how financial development affects growth? , and, what determines financial development? He concludes that financial intermediation can affect growth by acting on the saving rate, on the fraction of saving channeled to investment or on the social marginal productivity of investment.

Peter Howells and Keith Bain\textsuperscript{27}(1994) have given a recital on the ways in which financial system influence the real economy. To them, financial intermediation affects the composition and the level of aggregate demand and the resource allocation. It can have implications for the balance of production in an economy and upon the rate of growth of the economy if more resources are devoted to investment than would otherwise have been the case. The book ‘Financial Markets and Institutions’ gives a theoretical base on the relationship between financial development and economic growth. On capital market, it explains the characteristics of bonds, equities, its responses with the market rate of interest variations. It helps us to understand the behaviour of share prices and ratio indications.

Jagdish Bhagwati\textsuperscript{28}(1994) on ‘India In Transition’, has observed the peculiarities on India’s foreign trade and its relationship with investment. They are; India’s ‘export pessimism’, less industrialization, and industrial controls. Dr. Manmohan Singh has mentioned in his D. Phil thesis at Oxford under Ian Little in 1961 that India’s export pessimism was unjustifiable. It has also reduced India’s success with industrialization. Other countries with a smaller industrial base were not only exporting more manufactures than India but they were also catching up with India in the absolute size of their manufacturing sector. To put it simply, “India missed the bus on industrialization during

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\textsuperscript{26} Marco Pagano, ‘Financial markets and growth; An overview’. European Economic Review 37 (1993), 613-622, North Holland.
\end{flushright}
its quarter-century of weak economic performance”. Moreover, the deadly combination of industrial licensing and controls at home effectively cut off the rigors of competition from all sources and made the creation of a ‘rentier’, as against an entrepreneurial economy more likely.

In ‘Investment Finance in Economic Development’, Studart\textsuperscript{29} (1995) analyzed the role of savings and financial markets in economic growth by using a stock-flow model of finance-investment-saving circuit (FIS) from a Keynesian perspective. The FIS circuit as an analytical tool developed a systematic view of the role of banks, saving and financial markets in the process of growth. It concludes that finance is independent of previous saving, does not guarantee that growth can be sustainable from a financial perspective. Even in highly developed economies, growth is normally accompanied by increasing financial vulnerability of firms, banks and other financial institutions. Hence, saving and financial markets may play a fundamental role in a financially stable process of development.

How important are financial markets to the construction of a European economic system? What financial intermediaries do? How the economic growth process works? Robert G King and Ross Levine\textsuperscript{30} (1995) in their work ‘Financial Intermediaries and Economic Development’, observed that financial sector reform promote economic growth by improving the efficient allocation of resources. Countries with efficient financial intermediation sectors systematically outperformed other countries during the post World War II period. The study over 1960 – 89 for 114 countries revealed that; countries that grow faster have larger financial systems, have a predominant role of deposit money banks and a higher share of lending to the private sector than to the public sector. They predicted a rapid growth during 1970-89 in those countries which had larger

financial systems in 1960-9 and had a higher share of lending to the private. The study used partial correlation and regression methods for analysis.

According to J.C. Berthelemy and A. Varoudakis31 (1996), “financial sector reform has become inevitable to overcome external debt crisis and for efficient allocation of resources”. In their study on ‘Models of Financial Development and Growth: A Survey of recent literature’, it tests the size, structure and efficiency of the financial system, in 80-90 countries during the period 1960-89. The results demonstrate that those countries initially had a relatively well established financial system later on experienced a relatively higher growth in percapita GDP and higher investment/GDP ratio. While analyzing the consequences of financial repression, it observed that financial disintermediation which in turn reduces the size of the financial system; affect the efficiency of resource allocation to investment.

Demetriades and Luintel32(1996) examined the effects of various types of banking sector controls on the process of financial deepening in India. In ‘Financial Development, Economic Growth, and Banking Sector Controls: Evidence from India’, they described the development of Indian Financial System. This study constructed several indices, following the method of principal components and used Unrestricted Error Correction Method (UECM). Tests were applied to see the causality between financial development and economic growth. It used the data base of RBI, CD Rom on International Financial Statistics published by the IMF (1993) and concludes that financial policies affect growth only through their effects on financial deepening.

The monograph of Cho33(1996) investigates the impact of financial factors on corporate investment in Korea, using firm-level company accounts data for a balanced panel of 420 firms over the period 1983-1991. Financial liberalization has introduced in

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Korea in 1980s. The study on ‘Finance Factors and Corporate Investment’, focuses whether the investment spending of firms affiliated to ‘Chaebol’ industrial groups is different from the investment of non-group affiliated firms by financial constraints. The study observed that group firms tend to use more long-term external finance and less internal finance than non-group firms. On the background of financial deregulation, the non-group firms and smaller firms tended to increase their long-term finance and new equity finance more sharply than group-larger firms- in the later period. The findings, however, do not establish any relationship between financial factors and the investment spending of Korean corporations.

Joshi and Little\textsuperscript{34} (1996) distinguish the external and internal causes which led to the poor performance of Indian financial sector in general and the banking sector in particular since the second half of 1980. External causes are the regulatory environment in which the banks functioned. The internal factors are the short comings of internal organization. Pre-emption of bank resources, directed credit, administered interest rate, low port folio quality, lax regulation and supervision, low internal and organizational efficiency, lack of competition and political interference are some of them. The result of the above factors was ill suited to the task of allocating credit efficiently. It suggests the need to liberalize fully the capital account to optimize savings and investment and to achieve risk diversification. They also stress the need for cost-effective method of credit to achieve efficacy.

Joshi and Little (1997)\textsuperscript{35} describe the financial sector reform process and stress the imperative role of financial liberalization in their study on ‘India’s Economic Reforms 1991-2001’. They justified the interest rate deregulation, debt recovery and removal of concessional credit. The capital market regulations must be aimed to improve


the trade and settlement system, eliminate corruption and build investor confidence. In this study, they have analysed the financial crisis 1991, fiscal adjustment since 1991, banking and capital market reforms. Though India has made a good start with financial sector reform, it has to go a long way to create an efficient financial sector suitable for a sophisticated modern economy.

The study of R K. Dash and J. Panda36(1998) on ‘IDBI- Review of a Decade of Operations’, has made an attempt to evaluate the performance of development banks in general and the IDBI in particular with special reference to eastern India. It seeks to make an inter-institutional comparison of the operations of the Development Banks under different classifications of project finance. It covered a period of ten years from 1982-83 to 1991-92. The study used both primary and secondary data. The secondary data sources were primarily the Annual Reports and Operational Statistics of IDBI, Report on Development Banking published by IDBI, Economic Survey and Hand Book of Statistics of the Government of India and Report on Currency and Finance of RBI. The study observed that the existing institutional framework require an effective mechanism to coordinate and integrate the diverse institutions in the system.

In ‘India’s Economic Reforms; An Appraisal’, M.S. Ahluwalia37(1999) provides an appraisal of the performance of economic reforms in the crisis management period (1991-2 to 1993-4) and post stabilization period (1994-5 to 1997-8). According to him, “an encouraging aspect of India’s experience is the bahaviour of investment in the post reform period”. In India, the decline in public sector investment as a percentage of GDP in the post reform period was offset by an increase in private investment, unlike Latin American countries. The acceleration in the GDP growth in India even though investment rate was only marginally suggests that productivity growth was higher. He therefore,

addresses the issue of a high level fiscal deficit of the central and state governments. Unless this deficit is reduced, the economy will not be able to maintain low real interest rates which are inevitable to boost private investment.

In a study on ‘Institutional Change in India’s Capital Markets’, Shah\textsuperscript{38}(1999) described the radical reforms executed in the capital market of India after reforms. He observed that the establishment of four new institutions – SEBI, NSE, NSCC, and NSDL – considerably improved market efficiency and sharply lowered transactions costs. It compared the market efficiency of stock returns in the pre and post-reform periods. In 1993-94, and 1994-95, firms reduced their leverage through primary market issues of equity, debt-equity ratio of the corporate sector as a whole dropped from 2.04 in 1991-92 to 1.3 in 1994-95, and the ‘forecast accuracy’ of the market’s P/E has improved considerably. This reflects the institutional development on the capital market. The study analysed market efficiency and transaction cost during the 1991-98 period, however, it has not compared the financing of the corporate sector through various sources.

R.K. Jain\textsuperscript{39} emphasizes the need to make a strong banking system since it accounts for over 80% of the funds flowing through the financial system. It should be productive and efficient in the context of capital account convertibility because capital account convertibility results in large inflows and outflows which have implications on exchange rate management and domestic liquidity. He reviews the first phase financial sector reforms which bring in more transparency in the balance sheets of banks, introduction of capital adequacy norms, income recognition and asset classification norms, provisioning on vitiated loan assets, marking securities portfolio to market etc. In the second phase, competitive efficiency, emphasis on customer services, organizational

\textsuperscript{38} Ajay Shah, ‘Institutional Change in India’s Capital Markets’, Economic and Political Weekly, January 16-23, 1999

restructuring, technological upgradation, housekeeping and reconciliation of inter branch accounts.

In ‘Financial Liberalization and Economic Development in China’ Agarwal attempted to explain the role of financial liberalization in economic development in China. The financial development in China started during the 1980’s and globalization commenced since 1990’s with the inflow of FDI. About the impact of reforms on economic development, data indicates that “a growth rate of GDP of around 10% with macro economic stability has been sustained for about two decades”. Financial liberalization promoted competitiveness, efficiency and flexibility of the financial sector. The study observed that the allocative inefficiencies, growth of non-performing loans and the erosion of the capital base of the banking sector have been controlled with financial reform policy.

Agarwal in ‘Financial Integration and Capital Market in Developing Countries: A Study of Growth, Volatility, and Efficiency in the Indian Capital Market’, studied the impact of financial integration on Indian capital market. Big financial investors of the developed countries seeking higher returns find developing economies quite attractive destinations. The benefits of these processes are large for developing countries. The study observed that in spite of the benefits of financial integration the Indian stock market is still poorly integrated with the developed international capital markets. Its investor base is very small and turnover ratio is the lowest. The number of scrips traded on a regular basis in the stock markets is very small. He concludes that “the stock market efficiency has not improved significantly after the initiation of reforms”. Since the ratio of daily trading volume to total debt outstanding is less, there is problem of illiquidity.

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Abdur R. Chowdury\textsuperscript{42} (2001) in ‘The Impact of Financial Reform on Private Savings in Bangladesh’ analysed the behavior of the determinants of private savings in Bangladesh, in the context of financial sector reforms. Prior to the late 1980’s, Bangladesh has also been characterized by financial repression. However, Bangladesh has become one of the first countries in South Asia to embrace reform in the late 1980s. It has adopted a gradual approach to financial sector reform including the dismantling of a number of directed credit schemes, eased interest rate controls, strengthening the capital base of the banks, identification of non-performing assets, classification of assets provision for bad debts and prudential norms have been introduced. The results based on co integration tests and error correction models showed that financial reform had an adverse effect on savings. The underlying cause of this particular response was a consumption boom caused by financial reform and an increase in asset prices.

In the study ‘Financing the New Economy: Financial Institutions and Corporate Governance’, Mayer (2001)\textsuperscript{43} describes how do high tech firms finance themselves and what roles do stock markets play in their development? He cites the findings of Carlin and Mayer (2001)\textsuperscript{44} in 27 industries of 14 OECD countries over the period 1970 to 1995. It explained the stages of financing of high technology industries in the pre-IPO stage in the US and UK. In US and UK, the ‘start-up’ initial external capital largely comes from business angles (wealthy private investors) and venture capital funds. In the post-IPO stage the study cited the financing of Goergen (1998)\textsuperscript{15} that the average age of a firm coming to the German stock market has been 50 years, in UK it is around 12 years and in US around 6 years. Families hold majority stakes in nearly 50% of German firms where as UK families control only in 11% of firms. The study concludes that risk taking by

institutional investors in Europe is affected by “the emphasis placed by regulation on, in particular minority, investor protection”.

Aziz and Duenwald’s (2002) study on ‘Growth-Financial Intermediation Nexus in China’, during the post 1978 reform period addresses the questions mainly, what are the main characteristics of China’s system of financial intermediation? Do differing degrees of financial system development across China’s provinces help explain differences in growth performance? What are the policy implications of China’s financial sector reform program? The results point out that (1) Those provinces with above average GDP growth had bank loan-to-GDP ratios that were significantly lower than below average growth provinces. (2) Provinces with above average levels of financial intermediation experienced lower growth than provinces with below average levels of financial intermediation. Moreover, it observed that instead of financial development (total bank lending), non-bank sources of finance has played a significant role in financing China’s growth.

Petya Koeva (2003) provides certain new empirical evidence on the impact of financial liberalization on the performance of Indian commercial banks. On ‘The Performance of Indian Banks during Financial Liberalization’, the study particularly focused the questions relating to; cost of intermediation, profitability and its determinants. Using the balance sheet, data for all Indian commercial banks for the period 1991/92 to 2000/01, it observed that, the cost of financial intermediation and profitability has declined in recent years. The entry of new and foreign banks has resulted in the decline of bank intermediation costs, profitability and industry concentration. In this work, both cross-sectional and time series properties of the data are examined in a panel regression framework, a variety of models and estimation methods.

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Jun Nagayasu’s48 (2003) study on ‘The Efficiency of the Japanese Equity Market’, using the ARFIMA – FIGARCH model analysed the efficiency of the Japanese equity market by examining the statistical properties of the return and volatility of the Nikkei 225. By incorporating recent sample data (from 1/1/1990 to 8/8/2002) and using Auto Regressive Functionally Integrated Moving Average (ARFIMA) and Fractionally Integrated General Autoregressive Conditional Heteroskedasticity (FIGARCH) model, the study observed that the equity market remains inefficient despite recent implementation of financial market reforms. This paper points to a number of possible factors behind the absence of improvements in market efficiency despite the recent reduction in legal restriction in the Japanese equity market.

A study on ‘An Empirical Reassessment of the Relationship Between Finance and Growth’, re-examines the relationship between financial development and economic growth by Giovanni Favara49 (2003). It observed that financial development does not have a first-order effect on economic growth. The dataset refers to an unbalanced panel of 85 countries during the period 1960-1998. The control variables include the level of real percapita GDP (Y0), the average years of attainment in secondary and higher education (SEC), the ratio of export plus import over GDP (OPEN), black market premium on foreign exchange transactions (BMP), the ratio of government consumption to GDP (GOV), and the level of inflation rate (INF) and, the ratio of gross domestic investment to GDP (INV). The data source includes the International Financial Statistics of IMF, Penn World Table 6.1, Barro and Lee50 (2000), and Easterly and Sewadeh51 (2002).

How do the institutional framework and macroeconomic environment influence financing choices? In the work 'International Evidence on Aggregate Corporate Financing Decisions', Domowitz, Glen, and Madhavan\(^{52}\) (2004) examined the pattern of primary market financing using panel data on thirty countries from 1980-1997. It observed high correlation between macroeconomic stability and the development of bond market. The institutional framework also plays a crucial role in financing decisions. The key institutional factors include liquidity in the stock market, concentration in the banking system and the relative sizes of the banking and stock market. The overall results of the study suggest that the more stable the macro economy and the more mature its financial institutions, the more significant the role of bond markets. More stable economic environments are associated with higher levels of domestic financial markets.

**Specific Literature**

K. Krishnamurthy and D.U. Sastry\(^{53}\) (1975) have observed that the private corporate sector has continued to play an important role in the industrial development of the country. In the study 'Investment and Financing in the Corporate Sector in India', they specifically mentioned about the institutional framework of the industrial sector during the planning period. The analysis of trends in the private corporate sector during the decade 1961-71 revealed that accelerator, financial variables and inventory investment are crucial determinants of fixed investment in the Indian private corporate sector. The study used ordinary least square (OLS), and correlation methods.

If all firms have equal access to capital markets, its responses to changes in the cost of capital differ only because of its investment demand. On the other hand, if internal funds have a cost advantage over external finance, then firms' investment and financing


\(^{53}\) K. Krishnamurthy and D.U. Sastry, 'Investment and Financing in the Corporate Sector in India', Institute of Economic Growth, Delhi, 1975.
decisions are interdependent. Fazzari, Hubbard and Petersen\(^5\) (1988) on 'Financing Constraints and Corporate Investment', tests the hypothesis that if the cost advantage of external finance is small, retention practices should reveal little about investment. If the cost advantage is significant, their investment should be driven by fluctuations in cash flow when they have no low-cost source of investment finance. Based on Tobin's q-model, for the period 1969 to 1984 it observed that the group of firms facing binding financial constraints (class-1) retained 94% of their income. Firms in another group (class-3 – which paid out more than 40% as dividend), spend a much lower proportion of their cash flow on investment. This result supports the idea that constrained firms borrow up to their debt capacity, support the fact that financial factors affect investment. It has used annual Value Line data base updated in April 1986.

Whether private investment is more efficient and productive than public investment? Khan and Reinhart\(^6\) (1990) in their study on 'Private Investment and Economic Growth in Developing Countries', formulated a simple growth model that separates the effects of both. It is estimated for a cross section sample of 24 countries during the period 1970-79. The study observed that private investment and public investment appear to have different effects on the long-run rate of economic growth. By looking at only the direct effects of private and public investment it found that at best public investment has no statistically significant effect on growth. But public investment has positive indirect effects on growth. By providing the necessary infrastructure, public sector investment has strong influence on the rate and productivity of private capital formation. Considering only the direct effects of private and public investment, the study concludes that government should aim at creating conditions which make private


investment attractive. The data source includes IMF, International Financial Statistics and national sources. The study used regression methodology for analysis.

The study on 'Monetization, Financial Liberalisation, and Economic Development', by Prem S. Laumas (1990), examined the role of financial liberalization in India during the period 1954-55 to 1974-75. It addresses the issues like (1) Is money complementary with physical capital in the context of the demand for money function? (2) Is money complementary with physical capital in the context of an investment function? The empirical estimates point towards the complementarities between money and capital in estimating the demand for money function and investment function. The major policy conclusions of the study were (1) "since the rate of interest has a positive effect on the rate of capital formation and on the rate of economic growth, it is imperative that the monetary authority in India let the real interest rates find their equilibrium level in a free market environment". (2) Since the real rate of return on capital has a positive influence on domestic savings and investment, the monetary and fiscal authorities should ensure high and stable real rates of return on business investment.

It has been argued that the fragmented capital markets in less-developed countries retard the efficient allocation of resources. The study on 'Internal funds and corporate investment in India', by Athey and Laumas (1994), using firm-level data examined the importance of the accelerator, internal funds and depreciation for investment by manufacturing firms in India. For a sample of 464 manufacturing firms listed on recognized stock exchanges during the period 1978-1986, the study analysed the balance sheets and profit and loss statements, which published in the Stock Exchange Official Directory. The results of the study indicate that internal funds and depreciation have

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significant explanatory power in a sales accelerator model of investment and that there exists heterogeneity among firms in the link between internal funds and investment.

Absence of a proper estimate of net fixed capital stock has drastically reduced the usefulness of various economic studies. Raychaudhuri (1996)\textsuperscript{58} in the article ‘Measurement of Capital Stock in Indian Industries’, has made an attempt to find out a suitable estimate of the net fixed capital stock for the Indian industries at the disaggregated level. The author has tried to highlight various methodologies used in the estimation of capital stock in different studies. She described the Perpetual Inventory Accumulation method (PIAM), Pinell-Siles’ (1979)\textsuperscript{59} estimate of net investment, Ahluwalia’s (1985\textsuperscript{60}, 1991) estimates of gross capital stock and, the methodology of Dadi and Hashim (1973)\textsuperscript{61}. The study gives a clear-cut methodology to estimate capital stock based on ASI data alone and others based on ASI and NAS statistics.

Patnaik and Chandrasekhar (1996)\textsuperscript{62} in the article, ‘Investment, Export and Growth’, observed that “it is really the investment ratio which plays the crucial role in determining growth rate” rather than the much raised ‘hullabaloo’ on ‘efficiency of resource use’. It used cross-section data of World Bank for 25 major underdeveloped countries and estimated real GDP growth-rates for each of them by fitting semi-log trends for the period 1968-88. For investment ratio it has taken the simple average of the ratio of gross investment to GDP for each of these 25 countries for the entire period. Using regression and testing the ‘net investment’ and the ‘net domestic product’, the study observed that the investment ratio which plays a crucial role in determining the growth

\textsuperscript{61} Dadi M.M and B.R. Hashim (1973), ‘Capital Output Relations in Indian Manufacturing 1946-64’, M.S. University of Baroda, Baroda.
rate. The efficiency of resource use does not appear to be a particularly significant factor determining relative growth performance.

The study of Huisman and Hermes\(^{63}\) (1997) on 'Financial Liberalization in India and Impact on Business Investment', tests whether the liberalization process led to a reduction of financial market imperfections. They have analysed 100 Indian Companies using RBI and IDSS (Investment Decision Support System) data for the period 1984-1994. Two sub-samples - small versus large and young versus old - have created. The study found that the internal funds are an important source of finance for Indian business for their investment plans. This supports the hypothesis that both small and young firms have more difficulties in attracting external finance. The study concludes with the observation that financial liberalization in India has not really led to a reduction of financial market imperfections, at least not for the period until 1994. The study has not analysed the performance of a uniform set of companies during this period.

The study of Raghuram G. Rajan and Luigi Zingales\(^{64}\)(1998) examined the rationale between industrial sectors, external finance, developed financial markets during the period 1980-90. In their study 'Financial Dependence and Growth', they have compared the growth of the industries such as Drugs and Pharmaceuticals-which require more external finance- and Tobacco-which require little external finance- in various countries. It observed that in Malaysia- the most financially developed, Drugs and Pharmaceuticals grew at a 4% higher annual real rate than Tobacco. In Korea, which was moderately financially developed, Drugs grew at a 3% higher rate than Tobacco. In Chile- lowest financial development - Drugs grew at a 2.5% lower rate than Tobacco. Thus, financial development seems to affect relative growth rate of industries. The data source includes; (1) Industrial Statistics Yearbook by the UN Statistical Division (1993),

Does the stock market play a positive role in the process of growth of the Indian Economy? In the study ‘Stock Market Development and Economic Growth’, Makoto Nagaishi\textsuperscript{65}(1999) focuses more specifically to the domestic savings mobilization, foreign portfolio inflows, and bank credit to the commercial sector. The measures of stock market development from 1981 to 1995 includes; market capitalization divided by GDP (MC/GDP), total value traded divided by GDP (VT/GDP), turnover ratio (TOR), new capital issues of non government public limited companies divided by GDP, liquid liabilities divided by GDP (LL/GDP), quasi-liquid liabilities (M3-M1) divided by GDP (QLL/GDP), total deposit with banks divided by GDP (TDB/GDP), and bank credit to the commercial sector divided by GDP (BCCS/GDP). Using panel data, the study observed that; the functional relationship between stock market development and economic growth is dubious in the Indian context.

What is the significance of the private corporate sector in the Indian economy? Has the corporate sector in India grown? N. Shanta\textsuperscript{66} in her study on ‘Growth and Significance of the Private Corporate Sector; Emerging Trends’, (1999) observed that the share of private corporate enterprises in net value added in the economy increased from 10.2% in 1982-83 to 18.6% in 1995-96. In total manufacturing its share increased from 38% in 1982-83 to 52% in 1992-93 and in organized manufacturing its share increased from 66% in 1982-83 to 86% in 1992-93 in terms of contribution to net value added. In


terms of absolute growth, it used three indices – gross output, net value added and net fixed capital. These variables have been deflated to arrive at real growth; observed that, the private corporate sector experienced a declining phase from 1980-81 to 1988-89 and a rising phase from 1989-90 to 1993-94. The author has used RBI Bulletin, CSO-NAS, CSO-factor income (new series), ASI and Annual Reports on the Working and Administration of the Companies Act 1956 data base.

How financial sector matters for the process of economic development? R. N. Agarwal (2000) in 'Capital Market Development, Corporate Financing Pattern and Economic Growth in India', studied the relationship between, financial institutions, stock market development and financing behavior of the corporate sector, and the link between stock market development and economic growth in India since 1980’s. By using correlation matrix, it observed that there is high positive correlation between the development of banking sector and capital market. To estimate its contribution on economic growth, the study used a regression analysis. An analysis of monthly and annual data confirmed that with the development of both the segments the index of industrial production or the index of GDP has boosted in the Indian economy. The data source include Emerging Stock Market Factbook (IFC 1997), Indian Securities Market; A Review (NSE, 1999), BSE Official Directory, Report on Currency and Finance (Goi, 1998-99). The study however has not analyzed the trend in the capital market and its impacts on investment.

Sayuri Shirai (2002) observed the changes in corporate financing patterns in India during the reform period. In the study ‘Have India’s Financial Market Reforms Changed Firms’ Corporate Financing Patterns?’ she analyzed how the ‘low quality firms’ and ‘high quality firms’, differ in their financing pattern. It observed that, (1) Indian firms

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generally depend heavily on external sources than internal sources. Among external sources loans from banks and FIs have been more important means of finance. Equity finance is equally important but more volatile than loans. (2) Low quality firms tend to borrow more heavily from banks and FIs than high quality firms. Further, (3) Large firms are not only major new equity issuers but also those that hold greater share capital than others. It used regression technique for analysis. It was based on Prowess database for the period 1990-2001 used two types of data- the Flows of funds data and liabilities of the balance sheet of firms. The study has not analysed pre and post-reform changes.

Joseph, Nitsure and Sabnavis (2002)\textsuperscript{69} have made an attempt to examine the evolution of corporate financing pattern in India by identifying the type of financial structure that is supportive for long-term growth. The study, ‘Financing of Indian Firms; Meeting the Needs and Challenges of the Twenty-first Century’, observed the changing pattern of corporate finance in India for the period from 1972 to 1996. While analyzing the impact of liberalization on the sources of finance, the study mainly observed that the choice of external funds widened and the flow of direct and portfolio inflows from abroad increased. The relative share of bank loans in project cost somewhat increased, while that of debentures and bonds sharply declined after liberalization. In the analysis of corporate balance sheets, the study found that there has been a secular decline in the share of internal sources of funds during the last twenty-five years. The size-wise analysis stressed the dependence of small firms more on internal funds, the rising share of reserves and surplus with firm size, a highest proportion of share premium and debentures for large-sized firms and a high share of long-term borrowings for large firms. It has used CSO, RBI, CMIE, ICICI data base for analysis. It concluded with the observation that the liberalization of financial markets has increased domestic saving rate in the economy find higher rate of investment by the private corporate sector. Like the findings of Samuel

(1996)\textsuperscript{70}, Nagaraj (1996)\textsuperscript{71} and Singh (1995, 1997)\textsuperscript{72}, this study also observed a declining share of internal finance in corporate investment over the last twenty-five years. The study has not analysed pre and post reform changes of the same set of companies.

Ahluwalia (2002)\textsuperscript{73} gives an overview of the two contradictory forces in his study on ‘Reforming India’s Financial Sector: An Overview’. One is the thrust towards liberalization and the second in favour of stronger regulation. The study broadly approach the financial reforms adopted in India by evaluating the problems experienced by the Southern Core countries of Latin America which adopted excessively enthusiastic financial liberalization in the late 1970s. It concludes by saying that financial sector reforms by themselves cannot guarantee good economic performance that depends upon a number of other factors, including a favourable macro economic environment and the pursuit of much needed economic reforms in other parts of the real economy.

Mujumdar (2002)\textsuperscript{74} in his work on ‘Financial Sector Reforms and India’s Economic Development’, underline the need for looking at the capital market policies initiated as part of structural adjustment programmes in a macro economic perspective. While explaining the policies to develop the capital market in a developing economy, it says that no single type of financial system is suitable everywhere and at all times. For most developing countries, bank based finance appears to be more appropriate. The relevant experience of Japan and the Republic of Korea and Germany have been analysed by the author to establish the fact that bank credit can successfully allocate resources and

\textsuperscript{73} M.S. Ahluwalia, ‘Reforming India’s Financial Sector: An Overview’, Given in James A. Hanson and Sanjay Kathuria (ed) op.cit
\textsuperscript{74} N.A. Majumdar, ‘Financial Sector Reforms and India’s Economic Development’, Academic Foundation, New Delhi, Vol.11, 2002
can operate with very high leverage. The study concludes that the disproportionate importance currently being given to capital market in India appears to be misplaced.

In the study “Saving, Investment and Growth in India”, Athukorala and Sen (2002) analyses the determinants of private investment in India particularly business fixed investment and residential investment. While the variables like expected sales, interest rate or the relative price of new capital goods are the important determinants of business fixed investment, household’s wealth, interest rates, the average level of rents and the expected capital gains are more important in residential investment. The regression results on the determinants of private corporate and household investment brings out the fact that, the rate of change in the real rental cost of capital, income, public investment, and post-reform dummy have significant effect on corporate investment. Further, it observed that the 1991 reforms do not seem to have a perceptible effect on non-residential business investment. The study, however, didn’t attempt to look into the growth of private corporate investment in India in the reform period.

Demirguc-Kunt and Levine (2004) examined the relationship between financial structure and economic development for a cross-section of up to 150 countries. In their work on ‘Bank -Based and Market Based Financial Systems: Cross-Country Comparisons’, they have analyzed; how the size, activity, and efficiency of financial systems differ across different income percapita groups, what are the different patterns of financial structure as countries become richer and, what are the legal, regulatory and policy determinants of financial structure. The study observed that, financial development tends to be greater at higher income levels. The financial structure across different income groups showed that, in higher income countries financial systems tend to be more market based. On legal and regulatory context, it observed that countries with Common

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75 Prema Chandra Athukoral and Kunal Sen, “Saving, Investment and Growth in India”, Oxford University Press, New Delhi, 2002
Law tradition, strong protection for shareholder rights, good accounting standards, low levels of corruption, and no explicit deposit insurance tend to be more market based. The study used correlations and simple regression methods for analysis.

Rene Stulz\(^7\) (2004) in the study ‘Does Financial Structure Matter for Economic Growth? A Corporate Finance Perspective’, examined how the organization of financial activities affects the efficiency of valuable investment opportunities. He pointed out that “with a poor financial structure, the cost of capital is too high so that it is difficult for entrepreneurs to create firms and for these firms to invest efficiently”. The globalization of financial markets makes it possible for established firms to bypass the local financial structure. But in the case of new firms they are affected adversely by globalization because of the greater instability of financial intermediaries. The study concludes by saying that “with financial liberalization, local financial intermediaries can fund themselves abroad and can diversify their risks abroad so that they become more insulated from local shocks”.

The study on the ‘Financing and Investment Patterns of Indian Firms’ over the period 1971-72 to 1999-2000 by Seema Saggar\(^8\) (2005) at an aggregate and disaggregate level of major industry groups observed that the financing pattern of Indian firms is found to be debt based. On the investment side, investments in financial assets increased. The industry wise analysis of investment pattern revealed no undue changes in other investments than fixed asset formation since 1991. The financing pattern of several industries has undergone sharp changes during the period 1991-92 to 1995-96. On the association between financing and investment for Indian firms, it observed that there is a positive association between long-term debt and long-term investments. The study used RBI data base for a total of 4834 non-financial, non-government companies since 1971-


\(^8\) Seema Saggar, ‘Financing and Investment Patterns of Indian Firms’, Economic and Political Weekly, January 15, 2005, pp. 231-239.
It has analyzed the balance sheet of 2096 companies of which 218 were common for the last 30 years. It used consolidated balance sheet data of a group of companies which vary over the period. The study has used consolidated balance sheet data and do not give a firm level analysis.

Conceptual Framework

Balance Sheet: - The balance sheet is a statement which reports the values of properties owned by the enterprise and the claims of creditors and owners against these properties. It reveals the firm’s financial position on a particular date. The right hand side of the balance sheet contains the assets of the company and left hand side represents claims against these funds.

Assets: - The certainty that economic benefits will flow to the enterprise beyond the current accounting period and has a value is recognized as an asset. It may be tangible objects or intangible rights owned by an enterprise and carrying future economic benefits. The assets depict how the money has been utilized by the enterprise.

Current Assets: - Current assets are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. (The operating cycle is the period which is taken to complete the sequence of events right from purchase of materials or goods for cash to the realization of sales in cash and normally it is of one year)

Fixed Assets: - Fixed assets are assets of a relatively permanent nature used in the operations of business and not ‘intended for sale’.

Investments: - The investments of a firm in shares, debentures and bonds of other firms or government bodies for profit or control.

Miscellaneous Assets: - They represent deferred expenditures which represent pre-payments for services and benefits for period longer than the accounting period. They include – (i) preliminary expenses, (ii) discount or underwriting commission on issue of shares and debentures, (iii) advertising expenditure, (iv) debit balance of profit and loss account.
Intangible Fixed Assets: - They have no physical existence. The intangible assets confer certain exclusive rights and facilities so that one firm is in a position to earn more profits in comparison to other firm. These assets include — (i) goodwill, (ii) patent and trade mark, (iii) copyright, (iv) license and franchise. (Goodwill represents the excessive earning power of a firm, patents confer exclusive rights to use an invention, trade marks represent exclusive right to use certain names, symbols, labels, designs. Copyright relates to production and sale of literary, musical or artistic works, franchise or license represents contracts giving exclusive rights to perform certain functions or to sell certain services or products).

Liabilities: - Liabilities may be defined as the claims of outsiders against the firm. It indicates the amount made available for purpose of business and its source.

Current Liabilities/Short-term liabilities: - Current Liabilities are all short-term obligations generally due and payable within a year. They include; (i) trade creditors, (ii) bills payable, (iii) dividend and tax payable, (iv) bank overdraft, (v) outstanding expenses and deferred income.

Long-term Liabilities: - This represents borrowing of a firm payable after more than one year. It includes; (i) debentures/bonds, (ii) mortgages, loans, (iii) long-term loans from banks or financial institutions.

Net Worth (Owner's Equity/Shareholder's Funds/Net Capital Employed): - It is the excess of the firms' assets over its liabilities, current as well as long-term. It consists of two elements; (i) share capital and (ii) share holder's reserves.

Share Capital: - Share capital is the sum that belongs to the shareholders. The share holder's money is refundable only on the winding up of the company. The company owe it to the shareholders and is shown as liability in the balance sheet.

Paid-up Share Capital: - It is the initial amount of funds contributed by shareholders. It includes both equity share capital and preference share capital. If shareholders pay more than the par value of shares, the excess amount is known as share premium.
Reserves and Surplus: - It represents retained earnings. It means that part of the profits belonging to the shareholders which is not paid out to them as dividend, but ploughed back in the business. It includes; (i) revenue reserves, (ii) capital reserves and surplus. Revenue reserves are – general reserves, development rebate reserves, investment allowance reserves, debenture redemption reserves. Capital reserves are – revaluation of fixed assets, profits prior to incorporation, share premium reserves, profits arising out of forfeited shares etc.

Provisions: - Certain liabilities are known to exist at the time of balance sheet but exact amount thereof are not ascertainable. The commitments are to be adequately provided for. It includes gratuity, pension, dividend and tax provisions.

Inventory: - It includes raw material, goods in process, and finished goods etc. It is valued at cost or market value, whichever is lower.

Receivables: - The accounts receivables/ sundry debtors and advances given are usually shown at the amount due from the third parties, customers etc. The provision for doubtful debt is usually made on estimate basis in the event of debts becoming doubtful.

Trade Credit: - Trade credit is extended by the seller to the buyer. It includes bills of exchange etc. It is made available to companies who have sufficient financial reputation and goodwill. It facilitates the purchase of supplies without immediate payment. It does not involve the payment of interest, but the company has to forgo cash discount.

Relationship between Assets, Liabilities and Net Worth: - Assets: Assets are resources of the firm which are acquired from the funds provided by outsiders and owners of the firm.

That is; Assets = Liabilities + Net Worth, or, Liabilities = Assets – Net Worth, or, Net Worth = Assets – Liabilities.

Profit and Loss Account: - It is the scoreboard of the firm’s performance during a period of time. The earning capacity of a firm is reflected by profit and loss account or income statement. The revenues of an accounting period are matched with the expenses
incurred in earning the revenues and the difference between revenues and expenses is treated as profit or loss.

**Gross Profit:** - The gross profit is arrived at after reducing cost of sale from sales. The cost of sale includes raw materials, labour and other factory expenses.

**Net Profit:** - The net profit is arrived at after charging selling and administrative expenses. The selling and administrative expenses include office expenses, staff salary, telephone, telegram, selling expenses, car expenses, interest, building maintenance etc.

**Solvency of the Company:** - A company is solvent if its assets are greater than its outside liabilities. The outside liabilities do not include the shareholders funds ie, share capital plus reserves. ie, if percentage of shareholders funds is high the solvency of the company is good.

**Mutual Funds:** - Mutual funds are associations or trusts of public members who wish to make financial investments in financial assets for the mutual benefit of its members. The funds collected from the members are invested in a diversified portfolio of financial assets with a view to reduce risks and to maximize income/capital appreciation to its members on a pro-rata basis.

**Proprietorship Securities:** - Proprietorship securities represent shares of capital of a public limited company. They are (i) ordinary shares, (ii) preference shares.

**Ordinary Shares/ Equities:** - The holders have the right to participate in the annual profits of the company and do not confer any special rights or privileges. They comprise the largest category of corporate securities traded on the stock exchanges. They represent the residual ownership of a company.

**Preference Shares:** - Carry certain preferential rights in priority to ordinary shares in the payment of dividend and return of capital in the event of liquidation of the company.

**Creditorship Securities:** - It includes bonds and debentures.

**Debentures:** - A debenture is an acknowledgement of indebtedness given under the seal of the company containing a contract for the repayment of the principal sum at a specified
date or after a specified period's notice and for the payment of interest at a fixed rate percent until the principal sum is repaid.

**Bonds:** - Bonds are form of debentures. They constitute a part of an agreement between the company and the bondholder. The instrument containing the rights on the bondholder and obligations of the debtor company is called bond denture. Bonds may be secured, unsecured, redeemable, and irredeemable. Bonds are issued for a period of 10 years or more carrying a fixed rate of interest.

**Capital Structure of a Company:** - Capital structure is the permanent financing of the company representing long-term sources of capital ie, owner’s fund and long-term debt but excludes short term credit.

**Financial Structure:** - It refers to the way the company’s assets are financed. It represents all the long-term and short-term sources of capital.

**Assets Structure:** - Assets structure refers to total assets and their components. It includes all types of assets of the company i.e., fixed assets and current assets.

**Scheme of the study**

In the introductory chapter besides introduction, the role of capital market, the rationale of the study, the objectives and methodology and review of literature are outlined. The structure and dimensions of the growth of Indian financial system and specifically the capital market reforms and the developments of the capital market, forms the themes of the second and third chapter. The corporate investment and financing pattern based on RBI data of NGNF public limited companies over the period 1982-83 to 2002-03 have been discussed in the fourth and fifth chapters. In the sixth (1 – 3 chapters), the results of the analysis of investment and financing pattern of 150 companies during the period 1983-2003 are discussed. The summary of the findings and conclusion are given in the seventh chapter.

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17 Seema Saggar, ‘Financing and Investment Patterns of Indian Firms’, Economic and Political Weekly, January 15, 2005, pp. 231-239