Chapter 7

Summary and Conclusions

The link between the financial and the real sectors in an economy gets manifest through the role played by financial intermediaries and markets in allocating resources across competing uses. This role came in for greater attention in recent years mainly because the reforms of the financial sector in most countries were launched with the objective of improving the efficiency in the allocation of resources. Financial sector reforms in India have also been based on the same logic. Keeping in view the centrality of the allocation of resources in achieving the stated objective of the reforms, this study has been focused on analysing the pattern of resource allocation resulting from the reforms of the financial sector in India from the early 1990s.

The study takes explicit note of the fact that the financial sector reforms in India have not only targeted financial intermediaries and capital markets but also impinged on the financing constraints of the users of finance. The allocation of resources during the reform process has thus been a combined outcome of actions taken by financial intermediaries (and markets) on the one hand, and the response of the users of finance on the other.

On the supply side of financial sector, the study covers the changes in resource allocation by the banking sector and the developments relating to the non-banking finance companies. In terms of the users of finance, the study focuses on the private corporate sector and its use of external finance and issues relating to rural credit and financial inclusion. In all these chapters, the effort has been to integrate the response of the supply side of finance and the use of resources in the real sectors in order to throw light on the central issue of the thesis i.e. 'resource reallocation in a liberalizing economy'.

This chapter weaves together the findings and observations made in the study. These findings and observations need to seen in lights of the caveats and limitations of scope of this study indicated at the outset in chapter.
The study began by delineating the issues relating to allocation of resources in a liberalizing economy in chapter 1 and then outlined the initial conditions that characterised the Indian financial sector during the period prior to the reforms in Chapter 2. It was seen that controls exercised over financial intermediaries (through reserve requirements and credit controls) helped to pre-empt financial resources and reallocate them in line with plan priorities. At the same time, controls over the real (industrial corporate) sector exercised through a licensing regime effectively circumscribed the areas into which financial and real resources could be invested. In effect, administrative controls over the supply side and on the factors that shaped the demand for credit reinforced each other, and in turn, shaped the allocation of resources in India.

There were no doubt positive outcomes of State intervention in the financial sector that include the expansion of the banking network, an increase in the share of rural credit through institutional sources and the positive role played by development financial institutions in financing investment. On the negative side, the rigidity in pattern of allocation of credit got reinforced by the inability of banks (and financial institutions) to shift resources from inefficient firms and allocate them to new or more efficient firms. Lack of competition and innovation resulted in deterioration in banking services and in the profitability of banks, especially, the nationalized banks. These negatives overshadowed and even discredited many of the positive achievements and developments relating to the financial sector by the end of the 1980s.

The process of liberalization of the banking sector that commenced in the early 1990s gave greater independence to the banks in the pricing of credit. There was also greater flexibility in the allocation of credit due to a reduction in the preemption and a broadening of the definition of the priority sector. However, banks were increasingly subject to new prudential and income recognition norms that placed greater demands on bank capital. These changes effectively altered the conditions of supply of credit and set in motion the reallocation of credit across different sectors, borrower categories and over the interest rate spectrum. These changes have been analysed in Chapter 3.
The analysis of change in the distribution of credit by banks across different production sectors showed that banks preferred to increase the share of loans to the non-subsidized sectors such as personal loans, construction etc. The distribution of credit across the sectors showed a definite pattern with the share of certain sectors like agriculture, small-scale industries declining. The study shows that over the liberalization period, smaller companies and the agriculture sector may have had to increasingly rely on non-bank, non-institutional and informal sources due to the decline or bank intermediated financing as also the preference of banks to finance enterprises though securitized lending. Such a change can be expected to have benefitted mainly the corporate segment of the economy.

The changes in the sector wise composition of credit in turn was reflected in the distribution of credit over the interest rate range which shows that the cross subsidization that existed and got depicted in a bimodal distribution of credit over the interest rate range during the eighties got substantially altered by the end of the nineties.

The econometric analysis of the supply and demand for credit (based on a switching regression model) showed that banks came to be more sensitive to risks arising from lending to the real sector. The availability of collateral and the degree of risk associated with lending seems to have played an important role in influencing the pattern of redistribution of credit towards non subsidized sectors including personal loans. At the same time, the overall performance of banks in India, (including the public sector banks) improved in terms of profitability and other performance ratios thereby reflecting higher efficiency over the course of the reform period.

While the improved performance of the banks was an outcome of the reform process, the analysis in this study also lends support to the credit view that if the aggregate supply conditions of credit changes, be it in terms of the price of credit, the capital constraints faced by banks, or the risk conditions in the real economy, then the distribution of credit across different class of borrowers is likely to change.
The financial sector reforms in most developing countries have focused on the formal banking sector and the securities market. The response of non-bank financial intermediaries following the reforms has received comparatively less attention. However, several developing countries experienced rapid growth in the semi regulated segments of the financial sector, especially the private finance companies at the outset of the liberalization process. The Indian case has been in line with this experience. Finance companies in the private sector were quick to respond to the opportunities thrown open by economic reforms initiated in 1991, unlike commercial banks that adopted a wait and watch approach. There was rapid expansion in the number of private finance companies and in the scope of their activities. But this phase came to an end, rather abruptly in 1997, with the dramatic collapse of a relatively large private finance company and was followed by a series of closures of such companies. These developments were traced in chapter 4.

Following the overhaul of the regulatory framework governing the NBFCs, the period after 1997 was marked by a change in the composition in this segment. This segment has come to be dominated mainly by larger NBFCs that managed to survive besides a few new entrants. While it has not been possible to estimate the impact of the collapse of the NBFCs on the availability and distribution of finance, the contraction in this sector can be gauged from the fact that of the 36,269 applications received only 12,740 companies stand registered by RBI by the end of 2007-08 and of these, only about 360 have been allowed to accept deposits.

The improved regulation and supervision no doubt brought a greater degree of stability to this segment. However, finance companies as they existed till the mid 1990s played an important role in delivering credit to the unorganised sector and to small borrowers. The collapse of such a large number of NBFCs choked off credit and resources to a large section of borrowers at the lower end of the production and trade spectrum. Alongside, the banking sector had to cope with increased demand for capital provisioning. The void left behind by the disappearance of private sector NBFCs in such large numbers has in all likelihood remained unfilled for a prolonged period except for certain segments
like housing finance and personal loans (to the premium segments of the market) where finance from banks and the larger NBFCs continued and expanded.

The study also shows that during a phase characterized by a shift, from a regime of controls to one based on 'market discipline', there is likely to be a 'regulatory lag' that is characterized by trial and error and learning. If the gap continues for too long, agents take advantage of the possibility of regulatory arbitrage. The large scale entry of finance companies in the mid nineties characterized by a herd behavior has been a case in point. More importantly, the study shows that an abrupt change in the composition of the financial sector can disrupt flow of finance to specific segments of the economy. The collapse of finance companies and the subsequent transformation of this sector thus hold lessons from a regulatory perspective even for the rural sector that has seen the emergence of large number of micro finance institutions and self help groups which are rapidly becoming the new face of rural finance.

Along with the reforms of the credit sector, the economic reforms in India also provided a greater role for the private corporate sector, freedom to raise finances and in undertaking investment. The response of the private corporate sector to the reform process in terms of its financing and use of resources has been examined in chapter 5. The financial sector reforms, (in conjunction with the greater space available to the private corporate sector to invest) resulted in a shift in financial and real resources in favour of the private corporate sector and in turn, a rise in its share in gross capital formation. The rise in the importance of the private corporate sector is also seen in the composition of the corporate sector. The number as well as the share in the paid up capital of companies in the private sector increased in relation to those in the public sector.

Our study also shows that though public limited companies continued to dominate in all respects except numbers, the limited control structure of private limited companies found favour in terms of corporate diversification from the mid 1990s. Over the liberalisation process, private sector companies began to prefer to invest in the equity of unlisted closely held companies for starting new ventures. The fact that private limited companies have less stringent disclosure norms and
are not subject to the discipline of the financial market has implications from a regulatory perspective. The reasons for the increase in the number of private limited companies and linkages to the public limited companies in terms of commonality of ownership and the source of financing may need further investigation. These observations are more in the nature of a hypothesis that can merit a separate study.

External financing for companies is in general linked to financing of new investment. The analysis in this study shows that external funds continued to dominate the financing structure of Indian public limited companies in the private sector and this share even increased during the first half of the 1990s accentuating a 'reverse pecking order'. However, as the reforms of the financial sector got underway, from mid nineties, the share of internal funds increased as compared to external funds. This pattern is observed both in case of public limited companies as well as private limited companies. And within external funds, the share of equity financing increased as the dependence of the corporate sector on borrowing declined.

The increase in the share of equity may be attributed to the reform process which made it easier for public limited companies in the private sector to raise capital through the capital market with a new regulatory framework. Fiscal measures, on their part, changed the relative cost of raising equity capital, and also made it more attractive for investors to invest through the equity market. The rise in the share of equity is attributable to the liberalisation of the capital markets and the relaxation of the controls over the issue of capital prevailing earlier.

The fact that periods characterised by higher equity financing have also been succeeded by periods of high investment by the corporate sector suggests that as Indian companies began to embark on new ventures, they began to tap the equity markets in addition to internal finance. On the whole, the rise in the share of internal resources seems to suggest that companies in the Indian private corporate sector are increasingly conforming to the 'pecking order' observed in developed market economies with a preference for internal capital over external funds.
The trends relating to resource use by the corporate sector show that there was a sustained decline in inventories required per unit sales for the private corporate sector. This development goes to show that there has been a reduction in the working capital required (per unit of sales) for the private corporate sector. Alongside, there was also a reduction in expenses on certain items (per unit sales), such as wages and salaries. These developments have been sustained over the 1990s and beyond and point to more efficient management of physical and financial resources.

At the same time, there has also been a small but noticeable increase in the share of certain items of expenditure such as R&D and an increase in the exports to sales ratio for the private corporate sector. These are indicative of a response of the corporate sector in terms of market orientation and in the use of resources for achieving greater competitiveness. The asset utilisation ratios have also shown improvement over the latter part of the liberalisation period. Apart from the indicators based on ratios of quantities, it is also seen that there was a sustained decline in the effective interest rate, which is indicative of better treasury management.

Overall, the response of the private corporate sector to the economic reforms has been one of improved efficiency in resources use. These aggregate results are also supplemented by findings based on firm level analysis of determinants of leverage over the reform period.

The firm level analysis shows that both the Trade-Off and Pecking Order theories appear to have empirical support, suggesting that both agency costs and costs of information asymmetry are important determinants of leverage after liberalization. An important finding of this study is that lending became more risk conscious, a behavior notably absent under the administered interest rate regime. At the same time, it is seen that from the mid 1990s there is a positive relationship between size and leverage which indicates that firms in higher size percentiles are in a position to borrow more. This result is in line with the trade off theory which predicts lower agency costs associated with lending to larger firms. It also conforms with the observation based on bank lending patterns (in chapter 3) that
smaller firms may have found it increasingly difficult to raise external capital (debt).

The last part of the study (chapter 6) focuses on rural credit. This study suggests that much of the reform period was marked by the absence of a clear road map for agriculture and rural credit. There seems to have been an implicit assumption that the overall logic of freeing the banks from administrative controls and increasing competition was applicable to rural credit as well. In the process, the problems relating to rural and agriculture credit did not seem to draw much of a mention in the initial road map set out for the financial sector reforms. Financial liberalization was expected to have led to a reallocation of resources from a traditional to the modern sector and to better efficiency. This study shows that such a change indeed took place, albeit at a considerable cost to the rural economy. In fact, the part of the economy from where financial resources move away from was the rural sector. In effect, the financial sector reforms resulted in a setback for the rural sector.

The broadening of the definition of the priority sector, the entry of new private banks and the marked withdrawal of the banking network - together worked to reduce the availability of credit to the rural and agriculture sector. The trends in rural credit that followed through the 1990s included a narrowing of the bank branch network, a fall in the credit deposit ratio in rural areas and a decline in agriculture credit to small and marginal farmers. There was a rise in indebtedness of the rural and agriculture sector without a commensurate increase in incomes. There was little recognition of these trends till about 2004-05 after which the government had to take measures like announcing debt waiver and relief.

It is seen that after almost 15 years of reforms, the need to address the problem of rural credit resurfaced in terms of policy. The policy perspective since then has veered around to an acceptance that there has been deterioration in rural credit which needs to be addressed through measures for greater 'financial inclusion'. An important initiative to deal with financial exclusion during the entire reform period was the launch of the SHG-bank linkage programme by NABARD and the
expansion in the rural development programmes of the government that involved the formation of SHGs. In general, the experience of the SHG-bank linkage model seems to have been positive in achieving greater involvement of women and marginalised groups. It has also demonstrated the potential of integrating credit needs to productive activities through the self help group mode. While the spread of SHGs has had the strong support of the Government, the other mode of micro credit delivery through private initiative of micro finance institutions has been organic with little direct government involvement.

A major shortcoming of the decentralized approach (SHGs as well as the MFI models) is the uneven, skewed and limited coverage across large parts of the country. It is observed that the coverage of SBLC is low particularly in regions that are also underserved in terms of the formal banking system. As far as the MFIs are concerned, there continue to be serious ethical questions relating to the high cost of credit, strong arm methods adopted for recovery of loans and the lack of a regulatory framework.

The lesson that emerges from the developments through 1990-2007 is that an over simplified market model masked the complexity of rural credit and finance. Many of the ideas from the past like expanding the RRB network and reviving the lead bank approach are finding favour once again in policy discourse.

A major gap in long term debt funding for the corporate sector has also emerged and the problem is particularly acute in the absence of a developed debt market for corporate bonds. Not surprisingly, a turnaround on the role of development financial institutions is also taking place. The idea of providing long term support to some new institutions through tax free bonds has made a come back in view of the difficulty in accessing long term debt on a sustained basis for funding large infrastructure projects.

In conclusion, we may state that while financial liberalisation has indeed resulted in changes in the allocation of resources in India and has also improved the efficiency of the banking and the corporate sectors, the process of resource allocation has also resulted in imbalances in the economy and has left several segments
underserved. While it is certainly important to achieve greater efficiency in intermediation and to avoid excessive government intervention that can stifle financial innovation, at the same time, the emerging concerns on the need for inclusive growth, balanced regional development, and long term investment in the economy suggests that the State has to continue to play a proactive role.

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