Impact of Financial Sector Reforms on Economic Outcomes in India

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Abstract: The year 1991 after independence proved to be a milestone in the economic history of India. Earlier the country was going through a severe economic crisis. And this crisis forced the policy-makers of India to implement the new economic policy. The situation arising out of the crisis prompted the government to formulate policies aimed at bringing about price stabilization and structural reforms. Stabilization policies were aimed at correcting vulnerabilities, thereby correcting the fiscal deficit and the inverse balance of payments. In this context, in June 1991, the Narasimha Rao government gave a new direction to India's economy and the new economic policy was implemented in the form of economic reforms across the country. Under this new economic policy, the government allowed private companies to enter many such sectors, which were earlier reserved only for the government sectors. The main reason behind implementing this new economic policy was the continuous negative balance of payments. In the present article, the impact of financial sector reforms on economic outcomes in India has been studied.

Key Words: financial sector reforms, Securities firms, Mutual funds, Insurance, debt-equity, FDI, SEBI, SGL, NDS.

Introduction

The reforms of 1991 were a landmark moment in India's post-independence history that changed the nature of the economy in fundamental ways. The serious problem of balance of payments gave rise to the economic crisis in the year 1991. To deal with this, India's economic establishment launched a multi-pronged reform agenda to improve India's macroeconomic balance sheet and accelerate the pace of development.

Financial sector reforms in India in the nineties have undeniably advanced the objectives of significantly opening the constituent segments to competition and liberalised operations. India now has a world class equity markets infrastructure, measures are steadily being implemented to build up liquid debt markets and banks are moving towards, even if they remain some way off, international prudential norms.

Despite this progress, one may be forgiven for a lingering perception that, if one were to start scratching the surface, things do not seem to have changed decisively. There remains a disjunction in the reported systems and structures that have ostensibly been established for safe and efficient intermediation and the perception of its soft underbelly by various stakeholders. While the discerning reader is informed almost daily of some problem or the other, official statistics indicate that most efficiency parameters are non-threatening and even improving. Yet, even in academic and policy conclaves, there emerges a sense of widespread dissatisfaction (not to mention unease) regarding the possibility of systemic risk posed by the financial sector. While there are not many overt signs of failures, by way of defaults and payments crises, there are increasing signs of structural strains in the system. The banking system remains saddled with large amounts of bad loans. The recent years have seen a succession of distress in and failures of various intermediaries, necessitating the provision of “comfort and support” from government. Institutions remain characterised by both political and regulatory forbearance.

1991 Reforms and its Importance

The economic reforms that took place in 1991 were very comprehensive. They affected a large part of the economy. However, then the full benefits of those reforms could not be taken due to the lack of suitable political situation. In 1991, drastic changes were made in the rules and regulations with trade policy, industrial licensing, reforms in the banking sector, allowing foreign direct investment (FDI) very sparingly, no doubt these were at the macro economy, fiscal and structural level. It was a step that brought far-reaching changes. But perhaps we did not have faith in these reforms; we remained suspicious of private sector capital. We were also harmed by the illusion that economic development can happen only because of government spending.

Major changes took place in the banking sector due to the suggestions given in the report of the Narasimhan Committee. They got more autonomy to work. He was also given relief in the matter of giving loans to the priority sector and fixing the interest rates by the government. The establishment of the Securities and Exchange Board (SEBI) as an independent regulator was a significant change. However, there was no initiative to completely freeze banks or privatize financial units. Even in the privatization of public sector banks, we have not been successful and it remains a curse till now.

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It is clear from these things that the achievements we have achieved during the past period of economic reforms are in front of us in different forms today. These reforms accelerated the growth rate of the country, which helped to lift a large number of people out of poverty line. A report came out last year. Based on the data of 2005-2016, this report of NCHC claimed that 273 million people came out of the quagmire of poverty in this decade. During this, more and more people had access to education and health services. People got the freedom to buy the goods of their choice and a new era of entrepreneurs and small

businessmen came into existence. Along with this, the service sector has made an important place in the economy of the country. In 1991, where consumers had limited options, they are getting innumerable options today as compared to them.

Still, today we need a fast growth rate, so that poverty in the country can be reduced to a minimum and the standard of living of the people can be improved. Along with this, we have to improve a lot in physical as well as social infrastructure, innovation will have to be promoted. The benefits of technology will have to be embraced and efforts will have to be made to increase business by bringing openness in policies so that it can become the engine of development of the country.

Impact on competition

The reforms have altered the competitive structure of the various industries in the financial sector. Going in reverse order by barriers to entry, the situation may be summarised as follows:

Securities firms: The brokerage industry is the most competitive part of Indian finance. New entrants like Indiabulls, Geojit Securities and ICICI direct have come to be some of the biggest firms, and many large brokerage firms of the early 1990s have faded. There is vigorous competition, with birth and death by roughly a dozen firms every year. This is an area where foreign firms are able to compete on the domestic market.

Stock exchanges and depositories: These industries have become a duopoly between NSE and BSE, and NSDL and CDSL. There are no government- induced entry barriers preventing a new exchange/depository from coming up. In the case of depositories, there is an "open access", pro-competitive, legal framework which ensures that the market-share of a dominant depository does not inexorably go to 100%.

Mutual funds: UTI dropped from near 100% market share to below 25% in the mutual fund industry. A series of public sector mutual funds have proved unprofitable and have hence exited the industry. There are few difficult barriers faced in starting a new mutual fund. This is an area where foreign firms are able to compete on the domestic market.

Insurance : While many new insurance companies are now in operation, the domination of the public sector incumbents, LIC and GIG, has not been dented. Entry is possible, but foreign ownership is capped at 26%.

Banking : It is difficult to obtain permissions to start a bank. Foreign banks are practically banned from opening new branches. Even domestic banks have to take permission from the RBI, to open one branch at a time. Many rules have been designed to favour public sector banks. These weaknesses in policy have led to poor competition in banking.

Table 1 compares the country's 10 biggest banks in 2017-18 with the situation in 2004-05 13 years ago. The 10-firm concentration ratio decreased significantly from 92.86% to 35.48%. This suggests higher growth on the part of smaller banks. However, the names of the largest banks are remarkably similar. The new names for 2017-18 are shown in boldface in which only three new names have appeared and all three banks are private sector banks owned by foreign investors, whose management control is with Indians. Whereas there are no private or foreign banks other than ICICI Bank in the 2004-05 list. The dominance of the public sector is clearly visible in both the study years.

Table 1: Biggest 10 banks: 2004-05 versus 2017-18

	2004-05			2017-18	
	Bank	**Total assets**		**Bank**	**Total assets**
1	State Bank of India	460071	1	State Bank of India	3454752.00
2	ICICI Bank Ltd.	168435	2	ICICI Bank Ltd.	1124300.00
3	Punjab National Bank	126418	3	**HDFC Bank**	1103186.17
4	Canara Bank	110305	4	Punjab National Bank	765830.10
5	Bank of India	95004	5	Bank of Baroda	719999.77
6	Bank of Baroda	94664	6	**AXIS Bank**	703703.37
7	Union Bank of India	72442	7	Canara Bank	616886.10
8	Central Bank of India	68878	8	Bank of India	615184.34
9	Uco Bank	54589	9	**IDBI Bank**	351136.78
10	Oriental Bank of Commerce	54069	10	Central Bank of India	327350
	10-firm concentration ratio	62.99		10-firm concentration ratio	**35.48**

Bond market : The level of competition in the bond market today is similar to the pre-reforms telecommunications sector. Here, the regulator is a government agency which combines policy and regulation. The RBI plays the role in the bond market which the DOT used to play in telecom. There is a monopoly depository (SGL), run by the RBI. There is a monopoly clearing corporation (CCIL) which is owned by a consortium of banks. There is a monopoly exchange (NDS), run by the RBI. The monopolist controls rules of entry.

Impact on the debt vs. equity patterns in firm financing

There is an extensive literature that compares "bank-dominated" financial systems against "market-dominated" financial systems. In the latter, the dominant forces shaping the allocation of capital are the stock market and the bond market. In contrast, bank-dominated financial systems accord primacy to banks in shaping resource allocation. Since earlier financial sector reforms had a focus on equity market development in India, we seek to understand if these made an impact on the financing decisions of Indian firms. When seeking to understand corporate financial structure, researchers have a choice between flow and stock measures. Flow measures suffer from a lack of appropriate marking to market. For example, when tariffs are reduced, a large drop in the value of many factories ought to be registered in the year of tariff reduction. This is generally not captured by accounting procedures. Stock measures at book value suffer from difficulties with treatment

of inflation and depreciation. For example, old assets such as steel factories of TISCO tend to be wrongly portrayed on the balance sheet as having a low value. Now we present some evidence on changes in corporate financial sources based on market-value measurement of stocks, which does not suffer from the difficulties of measurement of flows.

Evidence for large companies : The debt and equity in accounting data for firms tells us about the structure of intermediation associated with the stock of capital in the firm. A measure of the success of the equity market reforms would be that firms are able to more readily access equity financing compared to debt. There is some evidence that this shift is taking place in India. We analyse the shift from debt to equity examining patterns in the debt-equity ratios for Indian firms between 1989 and 2004.

On the books of a firm, equity and debt are generally priced at historical value which leads to distorted inferences. In our analysis, we use the market value of equity. At any point in time, the market value of all firms is comparable, and constitutes a superior measure of the equity capital in a firm as compared with the book value of equity. One problem in using the market value is that the shares issued by some firms are highly illiquid, and the market values cannot be trusted. Hence, we limit ourselves to the universe of firms in the CMIE COSPI index, which consists of all firms where trading took place on at least 66% of the days in the last three months. For these firms, a reliable estimate of the market value of equity is readily available. Unlike equity, debt in India is an opaque market. Most firm debt is held in the form of loans rather than bonds. In addition, since there is no active corporate bond market in India, these bonds are not liquid and therefore cannot be valued using a market price. Hence, we use the book value of debt. We expect that this is likely to lead to an over-estimate of the value of debt, since corporate debt is high yield and generally trades at a discount to book value.

The debt-equity data for Indian firms from 1989-90 to 2004-05 are shown in Table 7. The traditional debt-equity ratios, based on book value, shows that the Indian corporate sector deleveraged dramatically from 1.82 in 1992-93 to 0.97 in 2004-05. The story is even more dramatic when the market value of equity is used: this shows deleveraging from 2.19 times in 1989-90 to 0.36 today.

The table shows that the period of successful equity market reforms (as opposed to a relatively stagnant banking sector and debt market) has been associated with a visible rise in the importance of equity as a source of financing. For large firms, the Indian financial system is moving to an equity market dominated one, rather than a banking dominated one. This is contrary to findings that the use of debt financing has increased over the last decade. The study finds that it is particularly so in emerging markets, where one of the factors driving the rise in debt financing has been higher domestic supply of funds. The other important factor is shown to be opening up to the international economy.

Table 7: Financing patterns of COSPI firms

Year	Net worth Rs. Crore	Borrowings Rs. Crore	Mkt. Cap. Rs. Crore	Debt-equity ratio	
				Book value	Market value
1989-90	57251	81936	37425	1.43	2.19
1990-91	70942	119226	55176	1.68	2.16
1991-92	79832	144513	213688	1.81	0.68
1992-93	96784	176448	140783	1.82	1.25
1993-94	130440	188152	326136	1.44	0.58
1994-95	186770	228337	343954	1.22	0.66
1995-96	232232	274652	400927	1.18	0.69
1996-97	266614	309156	375466	1.16	0.82
1997-98	303115	355763	444224	1.17	0.80
1998-99	327772	390536	444904	1.19	0.88
1999-00	368628	423518	842887	1.15	0.50
2000-01	403298	445073	494933	1.10	0.90
2001-02	420432	508018	563447	1.21	0.90
2002-03	464156	508165	545741	1.09	0.93
2003-04	522034	493936	1176976	0.95	0.42
2004-05	621838	602419	1673743	0.97	0.36

The data used is for the CMIE COSPI companies, to avoid spurious results associated with companies where negligible equity trading takes place. In 1989-90, the book value of equity of these companies was Us.57,251 crore and the book value of debt was Us.81,936 crore. This implied a debt-equity ratio of 1.43. However, the market value of equity was Rs.37,425 crore. Using this more-accurate value, the debt-equity ratio in 1989-90 worked out to 2.19.

Impact on the stock of capital in the economy

Another way of obtaining evidence on the alternative modes of firm financing is to examine the stock of capital associated with financing mechanisms. Intuitively, this may be viewed as the composition of the portfolio of a representative household in India at a point in time. Three key facts, as of December 2005, are:

- The market capitalisation of the largest 2,573 firms added up to Us. 24.71 trillion.
- The non-food credit of the (entire) banking system was Us. 12.95 trillion. It is estimated that 20% of this was to individuals, leaving 80% or roughly Rs. 10 trillion for firms.
- The market capitalisation of the corporate bond market was estimated at Rs. 4 trillion.

These three estimates are done on a marked-to-market basis, and do not suffer from the problems of accounting notions of value. This suggests that the securities markets shaped Rs.25 trillion of resources, compared with Rs.9 trillion through the banking system. This ratio is suggestive of the increasing domination of securities markets in resource allocation. Furthermore, it points to the domination of equity financing.

We may take away two useful messages from the estimates above: the securities markets to banking ratio is at least 25:9, and the equity/bonds/banks breakdown is at least 21:4:9. In either case, we have measured banking fully but undercounted the two kinds of securities.

These relationships are not an artifact of one point in time. After 1993, the market value of the COSPI companies has been substantially larger than the (market value) of non-food credit.

Conclusion

The reforms of the year 1991 helped the economy to come out of the crisis and then gain momentum. The present time is also the time to outline a credible new reform agenda that will not only accelerate GDP growth. Experience and economic theory tell us that the effects of such micro-meso-macro economic reforms can be manifold, exploiting their synergies. With these reforms, the Indian economy can grow at a faster pace in the next two decades.

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