Financial Liberalization in India: An Assessment of its Nature and Outcomes

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Financial sector reform, involving substantial liberalisation of regulatory control over markets, institutions and instruments, is at the centre of the engineered transition that developing countries have been through over the last three decades. It is now widely acknowledged that the process of financial reform has had economy-wide implications, not just for the relations between financial institutions and their clients and for the nature of operations of financial institutions, but for the manoeuvrability of the state when it comes to macroeconomic policy.

There are three broad objectives that the process of financial liberalization serves: (i) it opens the country to new forms and larger volumes of international financial flows, in order to attract a part of the substantially increased flows of financial capital to the so-called "emerging markets" since the late-1970s; (ii) to facilitate these inflows it liberalizes to differing degree the terms governing outflows of foreign exchange in the form of current account investment income payments and in the form of capital account transfers for permitted transactions; and (iii) it transforms the structure of the financial sector and the nature and operations of financial firms in a manner that makes the financial system resemble that in countries like the US and the UK.

It has been argued for sometime now that the first two of these, involving liberalization of controls on inflows and outflows of capital respectively, have resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises.[1] Analyses of individual instances of crises have tended to conclude that the nature and timing of these crises had much to do with the shift to a more liberal and open financial regime. What is more, crises rarely lead to controls on capital inflows and reduced dependence on them. Rather adjustment strategies emphasise further financial liberalization, resulting in a history of periodic financial failure.

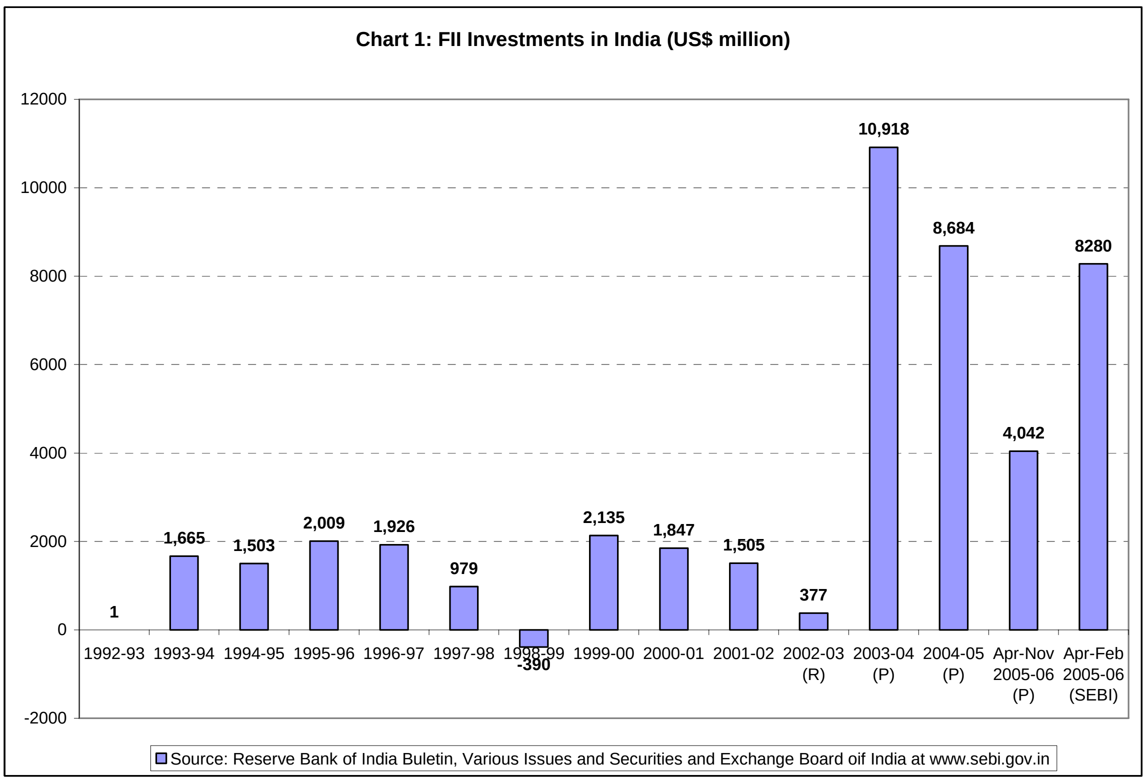
India, however, has not witnessed a currency crisis of the kind which afflicted a range of developing countries during the 1990s and thereafter. In fact, it has been argued that, because India (like China) has not liberalised its capital account to the extent done by many other developing countries, it managed to avoid or stave off the contagion that afflicted many East Asian countries in the late 1990s. However, India did experience a balance of payments crisis in 1990-91, resulting in it being subjected to an IMF-style adjustment programme that heralded the transition from a creeping process of liberalisation that characterised the 1980s to a more accelerated process of economic reform starting in 1991.

FII inflows and reform

From the point of view of this paper, what is crucial is that the crisis triggered a major reform of the financial sector that has been unfolding since, but has yet to culminate in

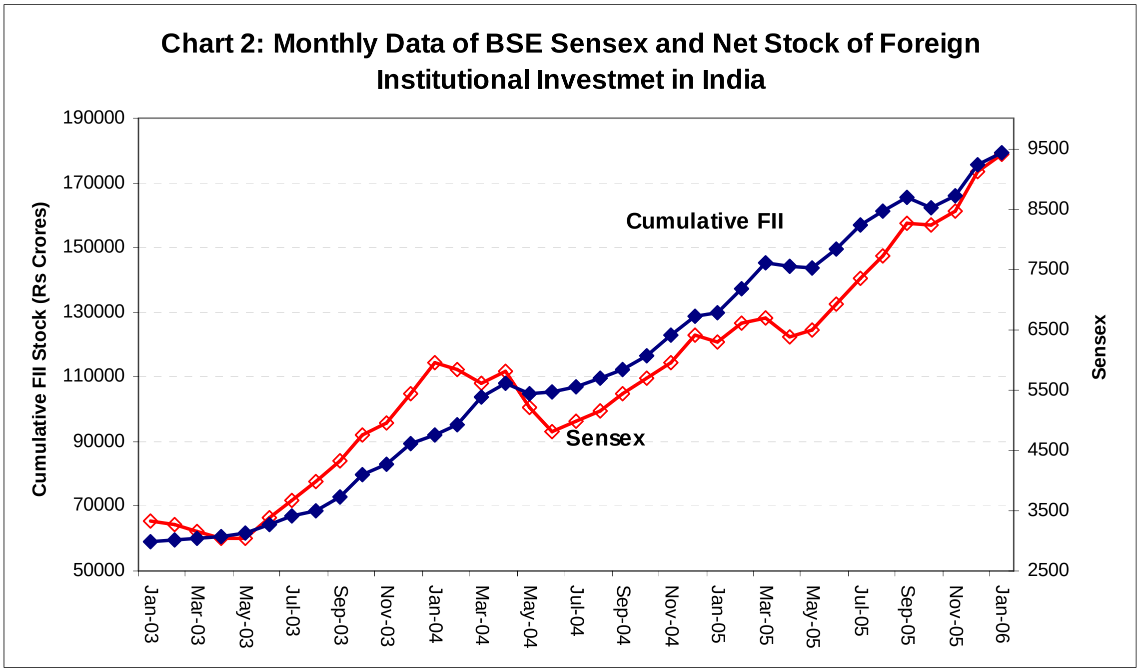
[1] For an early elaboration of this argument see Diaz-Alejandro (1985).

full convertibility on the capital account. A much-noted consequence has been a significant increase in the inflows of portfolio capital in particular years. As Chart 1 shows, one component of this, viz. the flows through foreign institutional investors, was relatively stable (excepting for a couple of years) during the period 1992-2002, but has recorded an extraordinary surge since April 2003. Having averaged $1776 million a year during 1993-94 to 1998-97, net FII investment dipped to an average of $295 million during 1997-99, influenced no doubt by the Southeast Asian crisis. The average rose again to $1829 million during 1999-2000 to 2001-02 only to fall $377 million in 2002-03. The surge began immediately thereafter and has yet to come to an end. Inflows averaged $9800 million a year during 2003-05 and are estimated at $8280 million during the first eleven months of 2005-06. Going by data from the Securities and Exchange Board of India (SEBI), while cumulative net FII flows into India since the liberalisation of rules governing such flows in the early 1990s till end-March 2003 amounted to $15,804 million, the *increment* in cumulative value between that date and the end of December 2005 was $25,267 million.



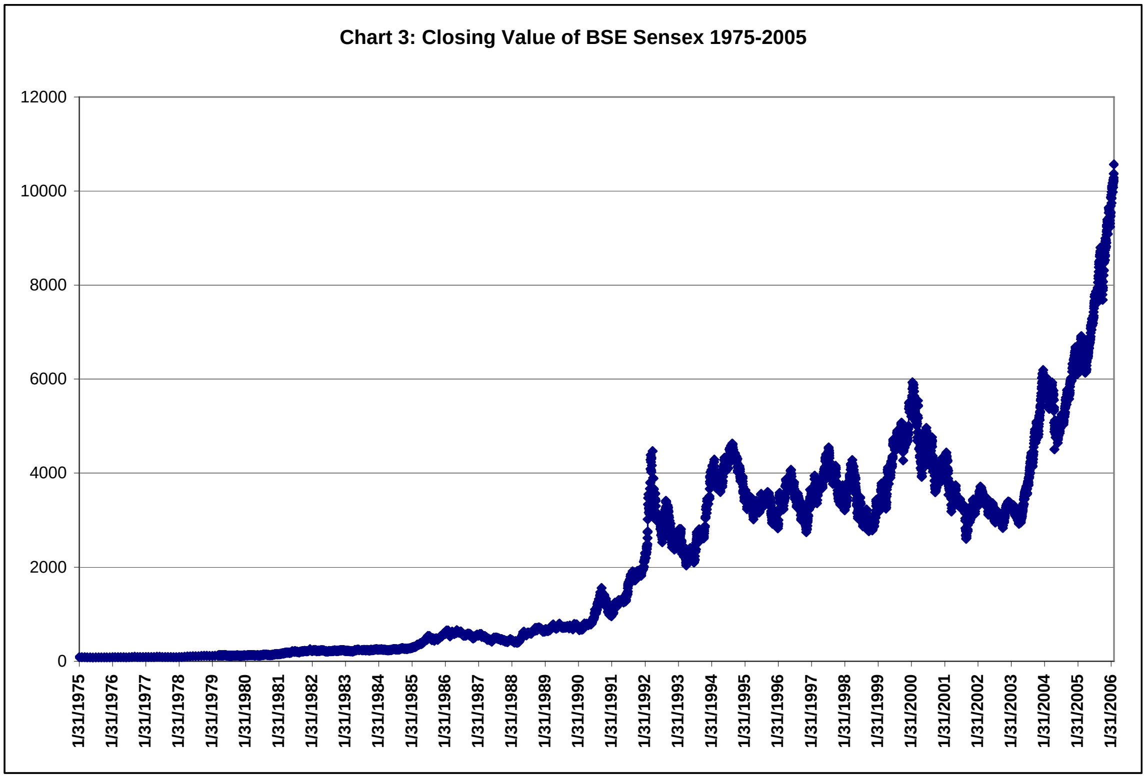
It is not surprising that the period of surge in FII investments was also one when, despite fluctuations, the stock market has been extremely buoyant. The Bombay Sensex rose from 3727 on March 3, 2003 to 5054 on July 22, 2004, and then on to 6017 on November 17, 2004, 7077 on June 21, 2005, 8073 on November 2, 2005, 9067 on December 9, 2005, 10082 on February 7, 2006 and 10113 on February 15, 2006. The implied price increases of more than 100 per cent over a 19-month period and 33 per cent over the last three and a half months are indeed remarkable.

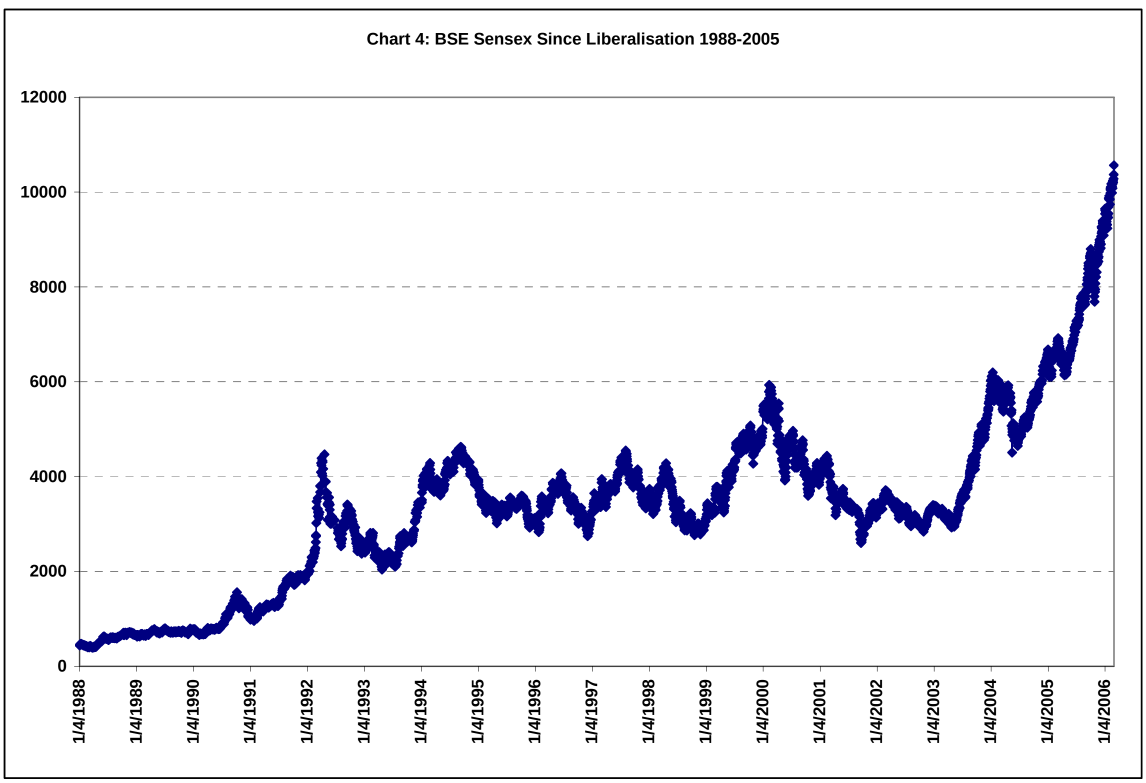
Market observers, the financial media and a range of analysts agree that FII investments have been an important force, even if not always the only one, driving markets to their unprecedented highs. In fact, as Chart 2 shows, the evidence is almost overwhelming, with a high degree of correlation between cumulative FII investments and the level of the Sensex.



Source: Websites of Bombay Stock Exchange (http://www.bseindia.com/histdata/hindices.asp) and Securities and Exchange Board of India (http://www.sebi.gov.in/Index.jsp?contentDisp=FIITrends).

Underlying the current FII and stock market surge is, of course, a continuous process of liberalisation of the rules governing such investment: its sources, its ambit, the caps it was subject to and the tax laws pertaining to it. It is well recognized that stock market buoyancy and volatility has been a phenomenon typical of the liberalization years. Till the late 1980s the BSE Sensex graph was almost flat, and significant volatility is a 1990s phenomenon as Chart 3 shows.





Source for Charts 3 & 4: Bombay Stock Exchange as quoted in Global Financial Data website at http://www.globalfinancialdata.com/index.php3?action=detailedinfo&id=2388.

An examination of trends since 1988, when the upturn began, points to the volatility in the Sensex during the liberalization years (Chart 4). And judging by trends since the early 1990s the recent surge is remarkable not only because of its magnitude but because of its prolonged nature.

It could, however, be argued that while the process of liberalisation began in the early 1990s, the FII surge is a new phenomenon which must be related to the returns now available to investors that make it worth their while to exploit the opportunity offered by liberalisation. The point, however, is that returns on stock market investment have been hiked through state policy adopted as part of the reform. As per the original September 1992 policy permitting foreign institutional investment, registered FIIs could individually invest in a maximum of 5 per cent of a company's issued capital and all FIIs together up to a maximum of 24 per cent. The 5 per cent individual-FII limit was raised to 10 per cent in June 1998. However, as of March 2001, FIIs as a group were allowed to invest in excess of 24 per cent and up to 40 per cent of the paid up capital of a company with the approval of the general body of the shareholders granted through a special resolution. This aggregate FII limit was raised to the sectoral cap for foreign investment as of September 2001. (Ministry of Finance, Government of India, 2005: 8-9). These changes obviously substantially expanded the role that FIIs could play even in a market that was still relatively shallow in terms of the number of shares that were available for active trading. In many sectors the FDI cap has been increased to 100 per cent and FII-cum-FDI presence in a number of companies is below the sectoral cap.

Further, the process of liberalisation keeps alive expectations that the caps on foreign direct investment in different sectors would be relaxed over time, providing the basis for foreign control. Thus, acquisition of shares through the FII route today paves the way for the sale of those shares to foreign players interested in acquiring companies as and when the demand arises and/or FDI norms are relaxed. This creates the ground for speculative forays into the Indian market. Figures relating to end-December 2005 indicate that the shareholding of FIIs in Sensex companies varied between less than 5 per cent in the case of WIPRO to as much as 66 per cent in the case of the Housing Development Finance Corporation (Table 1). This is partly because of the sharp variations in the promoters' shareholding. Not surprisingly, when we examine the FII share only in the free float equity of these companies, the spread reduces to between 21.9 and 73.4 per cent. However, given variations across companies, FIIs clearly hold a controlling block in some firms which can be transferred to an intended acquirer at a suitable price.

The fiscal trigger

But it was not merely the flexibility provided to FIIs to hold a high proportion of equity in domestic companies that was responsible for the stock market surge. The latter was partly engineered. Just before the FII surge began, and influenced perhaps by the sharp fall in net FII investments in 2002-03, the then Finance Minister declared in the Budget for 2003-04: "In order to give a further fillip to the capital markets, it is now proposed to exempt all listed equities that are acquired on or after March 1, 2003, and sold after the lapse of a year, or more, from the incidence of capital gains tax. Long term capital gains tax will, therefore, not hereafter apply to such transactions. This proposal should facilitate investment in equities." (Ministry of Finance, Government of India 2002: Paragraph 46).

Long term capital gains tax was being levied at the rate of 10 per cent up to that point of time. The surge was no doubt facilitated by this significant concession.

Table 1: Share Holding Pattern of FIIs in Sensex Companies in December 2005					
Company Name	**FIIs' Equity Shares on Dec -2005**	**Total Equity Dec 2005**	**Normal FII Share**	**Free Float Adjustment Factors as on 8th December 2005**	**FII Share in Free Float Shares**
Associated Cement Cos. Ltd.	43808622	184508237	23.74	0.70	33.92
Bajaj Auto Ltd.	20076196	101183510	19.84	0.70	28.34
Bharat Heavy Electricals Ltd.	54022422	244760000	22.07	0.35	63.06
Bharti Tele-Ventures Ltd.	481282270	1890061154	25.46	0.35	72.75
Cipla Ltd.	56325688	299870233	18.78	0.60	31.31
Dr. Reddy's Laboratories Ltd.	17042027	76538949	22.27	0.75	29.69
Grasim Industries Ltd.	17668828	91673438	19.27	0.80	24.09
Gujarat Ambuja Cements Ltd.	465162383	1352796500	34.39	0.75	45.85
H D F C Bank Ltd.	101439899	312181308	32.49	0.80	40.62
Hero Honda Motors Ltd.	53296997	199687500	26.69	0.50	53.38
Hindalco Industries Ltd.	183836775	927747970	19.82	0.75	26.42
Hindustan Lever Ltd.	302562522	2201243793	13.75	0.50	27.49
Housing Development Finance Corp. Ltd.	164614606	249332329	66.02	0.90	73.36
I C I C I Bank Ltd.	375206735	875127259	42.87	1.00	42.87
I T C Ltd.	383823050	2503424580	15.33	0.70	21.90
Infosys Technologies Ltd.	107899961	274525163	39.30	0.80	49.13
Larsen & Toubro Ltd.	26529506	134848582	19.67	0.90	21.86
Maruti Udyog Ltd.	48606036	288910060	16.82	0.30	56.08
N T P C Ltd.	565831187	8245464400	6.86	0.15	45.75
Oil & Natural Gas Corpn. Ltd.	119375709	1425933992	8.37	0.15	55.81
Ranbaxy Laboratories Ltd.	72216182	372442190	19.39	0.65	29.83
Reliance Energy Ltd.	36791332	201904251	18.22	0.50	36.44
Reliance Industries Ltd.	309347056	1393508041	22.20	0.55	40.36
Satyam Computer Services Ltd.	169912499	323306358	52.55	0.90	58.39
State Bank Of India	62616711	526298878	11.90	0.45	26.44
Tata Consultancy Services Ltd.	37067053	480114809	7.72	0.20	38.60
Tata Motors Ltd.	92795710	376256700	24.66	0.60	41.10
Tata Power Co. Ltd.	40263852	197897864	20.35	0.70	29.07
Tata Steel Ltd.	111902436	553472856	20.22	0.75	26.96
Wipro Ltd.	66396293	1420739099	4.67	0.20	23.37
Source: Prowess Database for Equity Holding Data and BSE website for the data on Free Float Adjustment Factors					

What needs to be noted is that the very next year, the Finance Minister of the UPA government endorsed this move. In his 2004 budget speech he announced his decision to "abolish the tax on long-term capital gains from securities transactions altogether." (Ministry of Finance, Government of India 2004: Paragraph 111). It is no doubt true that he attempted to introduce a securities transactions tax of 0.15 per cent to partially neutralise any loss in revenues. But a post-budget downturn in the market forced him to reduce the extent of this tax and curtail its coverage, resulting in a substantial loss in revenue. Thus, an extravagant fiscal concession appears to have triggered the speculative surge in stock markets that still persists.

The implications of this extravagance can be assessed with a simple calculation which, even while unsatisfactory, is illustrative. Let us consider 28 of the 30 Sensex companies for which uniform data on daily share prices and trading volumes are available for the years 2004 and 2005 from the Prowess Database of the Centre for Monitoring the Indian Economy.[2] Long term capital gains were defined for taxation purposes as gains made on those assets held by the purchaser for at least 365 days. These gains were earlier being taxed at the rate of 10 per cent.

Assume now that *all* shares of these 28 Sensex companies bought on each trading day in 2004 were sold after 366 days or the immediately following trading day in 2005. Multiplying the increase in prices of the shares concerned over these 366 days by the *assumed* number of shares sold for each day in 2005, we estimate the total capital gains that could have been garnered in 2005 at Rs. 78,569 crore. If these gains had been taxed at the rate of 10 per cent prevalent earlier, the revenue yielded would have amounted to Rs. 7,857. That reflects the revenue foregone by the state and the benefit accruing to the buyers of these shares. It is indeed true that not all shares of these companies bought in 2004 would have been sold a year-and-one-day later. But some shares which were purchased prior to 2004 would have been sold during 2005, presumably with a bigger margin of gain. And this estimate relates to just 28 companies. In practice, therefore the estimate provided is likely to be an underestimate of total capital gains from transaction that would have been subject to the capital gains tax. While it needs to be noted that the surge in the market may not have occurred if India had not been made a capital gains tax haven, the figure does reflect the kind of gains accruing to financial investors in the wake of the surge. Once the FII increase resulting from these factors triggered a boom in stock prices, expectations of further price increases took over, and the incentive to benefit from untaxed capital gains was only strengthened.

The problem of volatility

Given the presence of foreign institutional investors in Sensex companies and their active trading behaviour, small and periodic shifts in their behaviour lead to market volatility. Such volatility is an inevitable result of the structure of India's financial markets as well. Markets in developing countries like India are thin or shallow in at least three senses. First, only stocks of a few companies are actively traded in the market. Thus, although there are more than 8000 companies listed on the stock exchange, the BSE Sensex incorporates just 30 companies, trading in whose shares is seen as indicative of market activity. Second, of these stocks there is only a small proportion that is routinely available for trading, with the rest being held by promoters, the financial institutions and others interested in corporate control or influence. And third, the number of players trading these stocks is also small. According to the Annual Report of the Securities and Exchange Board of India for 1999-000, shares of only around 40 per cent of listed companies were being traded. Further: "Trading is only on nominal basis in quite a large number of companies which is reflected from the fact that companies in which trading took place for 1 to 10 trade days during 1999-2000, constituted nearly 56 per cent of 8020 companies or nearly 65 per cent of companies were traded for 1 to 40 days. Only 23 per cent were traded for 100 days and above. Thus, it would be seen that during the year

[2] In one case (Larsen & Toubro), data on trading volumes were not available in Prowess for 25 out of 254 trading days in 2004). For those days, we use the annual average trading volume as a proxy.

under review a major portion of the companies was hardly traded." (SEBI 2000: 85). The net impact is that speculation and volatility are essential features of such markets.

These features of Indian stock markets induce a high degree of volatility for four reasons. In as much as an increase in investment by FIIs triggers a sharp price increase, it would provide additional incentives for FII investment and in the first instance encourage further purchases, so that there is a tendency for any correction of price increases to be delayed. And when the correction begins it would have to be led by an FII pull-out and can take the form of an extremely sharp decline in prices.

Secondly, as and when FIIs are attracted to the market by expectations of a price increase that tend to be automatically realised, the inflow of foreign capital can result in an appreciation of the rupee vis-à-vis the dollar (say). This increases the return earned in foreign exchange, when rupee assets are sold and the revenue converted into dollars. As a result, the investments turn even more attractive triggering an investment spiral that would imply a sharper fall when any correction begins.

Thirdly, the growing realisation by the FIIs of the power they wield in what are shallow markets, encourages speculative investment aimed at pushing the market up and choosing an appropriate moment to exit. This implicit manipulation of the market if resorted to often enough would obviously imply a substantial increase in volatility.

Finally, in volatile markets, domestic speculators too attempt to manipulate markets in periods of unusually high prices. For example, the SEBI had issued show cause notices to four entities relating to their activities in and around Black Monday, May 17, 2004, when the Sensex recorded a steep decline.

All this said, the last three years have been remarkable because, even though these features of the stock market imply volatility there have been more months when the market has been on the rise rather than on the decline. This clearly means that FIIs have been bullish on India for much of that time. The problem is that such bullishness is often driven by events outside the country, whether it be the performance of other equity markets or developments in non-equity markets elsewhere in the world. It is to be expected that FIIs would seek out the best returns as well as hedge their investments by maintaining a diversified geographical and market portfolio. The difficulty is that when they make their portfolio adjustments, which may imply small shifts in favour of or against a country like India, the effects it has on host markets are substantial. Those effects can then trigger a speculative spiral for the reasons discussed above, resulting in destabilising tendencies.

Possible ripple effects

These aspects of the market are of significance because financial liberalisation has meant that developments in equity markets can have major repercussions elsewhere in the system. With banks allowed to play a greater role in equity markets, any slump in those markets can affect the functioning of parts of the banking system. For example, the forced closure (through merger with Punjab National Bank) of one bank (Nedungadi Bank) was the result of the losses it suffered because of over exposure in the stock market.

On the other hand if FII investments constitute a large share of the equity capital of a financial entity, as seems to the case with the Housing Development Finance Corporation (HDFC), an FII pull-out, even if driven by developments outside the country can have significant implications for the financial health of what is an important institution in the financial sector of this country.

Similarly, if any set of developments encourages an unusually high outflow of FII capital from the market, it can impact adversely on the value of the rupee and set off speculation in the currency that can in special circumstances result in a currency crisis. There are now too many instances of such effects worldwide for it to be dismissed on the ground that India’s reserves are adequate to manage the situation.

The case for vulnerability to speculative attacks is strengthened because of the growing presence in India of institutions like Hedge Funds, which are not regulated in their home countries and resort to speculation in search of quick and large returns. These hedge funds, among other investors, exploit the route offered by sub-accounts and opaque instruments like participatory notes to invest in the Indian market. Since FIIs permitted to register in India include asset management companies and incorporated/institutional portfolio managers, the 1992 guidelines allowed them to invest on behalf of clients who themselves are not registered in the country. These clients are the ‘sub-accounts’ of registered FIIs. Participatory notes are instruments sold by FIIs registered in the country to clients abroad that are derivatives linked to an underlying security traded in the domestic market. These derivatives not only allow the foreign clients of the FIIs to earn incomes from trading in the domestic market, but to trade these notes themselves in international markets. By the end of August 1995, the value of equity and debt instruments underlying participatory notes that had been issued by FIIs amounted to Rs. 78,390 crore or 47 per cent of cumulative net FII investment. Through these routes, entities not expected to play a role in the Indian market can have a significant influence on market movements (Ministry of Finance, Government of India 2005).

Financial flows and fiscal contraction

Growing FII presence is disconcerting not just because such flows are in the nature of “hot money” which renders the external sector fragile, but because the effort to attract such flows and manage any surge in such flows that may occur has a number of macroeconomic implications. Most importantly, inasmuch as financial liberalization leads to financial growth and deepening and increases the presence and role of financial agents in the economy, it forces the state to adopt a deflationary stance to appease financial interests. Those interests are against deficit-financed spending by the state for a number of reasons. First, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is “autonomous” in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Third, if deficit spending leads to a substantial build-up of the state’s debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, the use of deficit spending to support autonomous expenditures by the state amounts to an implicit legitimisation of an interventionist state, and therefore, a de-legitimisation of the market. Since global finance seeks to de-legitimise the state and legitimise the market, it strongly opposes deficit-financed, autonomous state spending (Patnaik 2005).

Efforts to curb the deficit inevitably involve a contraction of public expenditure, especially expenditure on capital formation, which adversely affects growth and employment; leads to a curtailment of social sector expenditures that sets back the battle against deprivation; impacts adversely on food and other subsidies that benefit the poor; and sets off a scramble to privatise profit-earning public assets, which render the self-imposed fiscal strait-jacket self-perpetuating. All the more so since the finance-induced pressure to limit deficit spending is institutionalised through legislation like the Fiscal Responsibility and Budget Management Act passed in 2004 in India, which constitutionally binds the state to do away with revenue deficits and limit fiscal deficits to low, pre-specified levels.

Implications of curbing the monetised deficit

This macroeconomic fall-out and its effects are aggravated by the perception that accompanies the financial reform that macroeconomic regulation should rely on monetary policy pursued by an "independent" central bank rather than on fiscal policy. The immediate consequence of this perception is the tendency to follow the IMF principle that even the limited deficits that occur should not be "monetised". In keeping with this perception, fiscal reform involved a sharp reduction of the "monetised deficit" of the government, or that part which was earlier financed through the issue of short-term, *ad hoc* Treasury Bills to the Reserve Bank of India, and its subsequent elimination.[3] Until the early 1990s, a considerable part of the deficit on the government's budget was financed with borrowing from the central bank against *ad hoc* Treasury Bills issued by the government. The interest rate on such borrowing was much lower than the interest rate on borrowing from the open market. The reduction of such borrowing from the central bank to zero resulted in a sharp rise in the average interest rate on government borrowing.

The reduction, in fact the elimination, of *ad hoc* issues, was argued to be essential for giving the central bank a degree of autonomy and monetary policy a greater role in the economy. This in turn stemmed from the premise that monetary policy should have a greater role than fiscal manoeuvrability in macroeconomic management. The principal argument justifying the elimination of borrowing from the central bank was that such borrowing (deficit financing) is inflationary.

The notion that the budget deficit, defined in India as that part of the deficit which is financed by borrowing from the central bank, is more inflationary than a fiscal deficit financed with open market borrowing, stems from the idea that the latter amounts to a draft on the savings of the private sector, while the former merely creates more money. In a context in which new government securities are ineligible for refinance from the RBI,

[3] This was more or less "successfully" implemented in a two stage process, involving initially a ceiling on the issue of Treasury Bills in any particular year, and subsequently the abolition of the practice of issuing Treasury Bills and substituting it with limited access to Ways and Means advances from the central bank for short periods of time.

and the banking system is stretched to the limit of its credit-creating capacity, this would be valid. However, if banks are flush with liquidity (as has been true of the Indian economy since at least 1999), government borrowing from the open market adds to the credit created by the system rather than displacing or crowding out the private sector from the market for credit (Patnaik 1995) .

But more to the point, neither form of borrowing is inflationary if there is excess capacity and supply side bottlenecks do not exist. Since inflation reflects the excess of *ex ante* demand over *ex ante* supply, excess spending by the government financed through either type of borrowing, is inflationary only if the system is at full employment or is characterised by supply bottlenecks in certain sectors. In the latter half of the 1990s, the Indian industrial sector was burdened with excess capacity, and the government was burdened with excess foodstocks (attributable to poverty and not true food “self-sufficiency”) and high levels of foreign exchange reserves. This suggests that there were no supply constraints to prevent "excess" spending from triggering output as opposed to price increases. Since inflation was at an all time low, this provided a strong basis for an expansionary fiscal stance, financed if necessary with borrowing from the central bank. So in the late-1990s context a monetised deficit would not only have been non-inflationary, but it would also have been virtuous from the point of view of growth.

It is relevant to note here that the decision to eliminate the practice of monetising the deficit hardly affected the fiscal situation. Fiscal deficits remained high, though they were financed by high-interest, open-market borrowing. The only result was that the interest burden of the government shot up, reducing its manoeuvrability with regard to capital and non-interest current expenditures. As a result the Centre's revenue expenditures rose relative to GDP, even when non-interest expenditures (including those on subsidies) fell, and the fiscal deficit continued to rise.[4]

An obvious lesson from that experience is that if the government had not frittered away resources in the name of stimulating private initiative, if it had continued with earlier levels of monetising the deficit and also dropped its obsession with controlling the total fiscal deficit, especially at the turn of the decade when food and foreign reserves were aplenty, the 1990s would have in all probability been a decade of developmental advance. Yet the policy choices made ensured that neither was this achieved, nor were the desired targets of fiscal compression met. It is evident that the failure of the government to realise its objective of reining in the fiscal deficit was a result of this type of economic reform rather than of abnormal expenditures.

Financial flows and exchange rate management

The question that remains is whether this “abolition” of the monetised deficit in order to appease financial capital actually results in central bank independence. On September 9, 2005 India’s foreign exchange reserves exceeded $145 billion, having risen from $76.1 billion at the end of March (Reserve Bank of India 2006: S168). It has since hovered in the $140-145 billion range. The process of reserve accumulation is the result of the pressure on the central bank to purchase foreign currency in order to shore up demand and dampen the effects on the rupee of excess supplies of foreign currency. In India’s

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[4] For an estimate of the impact the end to monetisation had on the government’s budget refer Chandrasekhar and Ghosh (2004), p. 81.

liberalized foreign exchange markets, excess supply leads to an appreciation of the rupee, which in turn undermines the competitiveness of India’s exports. Since improved export competitiveness and an increase in exports is a leading objective of economic liberalization, the persistence of a tendency towards rupee appreciation would imply that the reform process is internally contradictory. Not surprisingly the RBI and the government have been keen to dampen, if not stall, appreciation. Thus, the RBI’s holding of foreign currency reserves rose as a result of large net purchases.

Unfortunately, the RBI’s ability to persist with this policy without eroding its ability to control domestic money supply was in time weakened. Increases in the foreign exchange assets of the central bank amount to an increase in reserve money and therefore in money supply, unless the RBI manages to neutralise increased reserve holding by retrenching other assets. If that does not happen the overhang of liquidity in the system increases substantially, affecting the RBI’s ability to pursue its monetary policy objectives. Till recently the RBI has been avoiding this problem through its sterilisation policy, which involves the sale of its holdings of central government securities to match increases in its foreign exchange assets. But even this option has now more or less run out. Net Reserve Bank Credit to the government, reflecting the RBI’s claims on the central and state governments net of government deposits with the RBI fell from Rs. 1,20,679 crore at the end of March 200 to Rs. 44,907 crore at the end of March 2004 and a negative Rs. 17,975 crore by end-March 2005 (Reserve Bank of India 2006: S114). It has fluctuated in the negative range since. There was little by way of sterilisation instruments available with the RBI.

There are two consequences of these developments. First, the monetary policy of the central bank, that has been delinked from the fiscal policy initiatives of the state, with adverse consequences for the latter, is no more independent. More or less autonomous capital flows influence the reserves position of the central bank and therefore the level of money supply, unless the central bank chooses to leave the exchange rate unmanaged, which it cannot. This implies that the central bank is not in a position to use the monetary lever to influence domestic economic variables, however effective those levers may be. Secondly, the country is subject to a drain of foreign exchange inasmuch as there are substantial differences between the repatriable returns earned by foreign investors and the foreign exchange returns earned by the Reserve Bank of India on the investments of its reserves in relatively liquid assets. While partial solutions to this problem can be sought in mechanisms like the Market Stabilisation Scheme (which places government securities in a market stabilisation facility that increases the interest costs borne by the government), it is now increasingly clear that the real option in the current situation is to either curb inflows of foreign capital or encourage outflows of foreign exchange.

The RBI’s answer to the difficulties it faces in managing the recent surge in capital inflows, which it believes it cannot regulate, is to move towards greater liberalisation of the capital account (see RBI 2004). Full convertibility of the rupee, lack of which is seen as having protected India against the Asian financial crisis of the late-1990s, is now the final goal.

Financial liberalization and financial structures

But besides these difficulties resulting from external financial liberalisation, there are a number of adverse macroeconomic effects of what could be termed internal financial liberalisation necessitated in large part by the effort to attract portfolio and direct foreign investment. There are a number of aspects and consequences to such liberalisation as implemented in practice. To start with, it involves reducing or doing away with controls on the interest rates or rates of return charged or earned by financial agents. In practice this never means that the range of interest rates are completely "market determined". The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government influences interest rates by altering administered interest rates offered on small savings and pension/provident fund depositors.

While liberalization does not, therefore, fully "free" interest rates, it has other kinds of consequences. It encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. Competition in these spheres not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volumes to shore up their bottom line. That is, within the range implicitly set by the central bank (and at times the government) banks can be encouraged by liberalization of rates to accept lower spreads in the hope of neutralising the effects on profits by attracting larger volumes of business.[5]

The second feature of financial liberalization is that it removes or dilutes controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This aspect of liberalization inevitably applies to both domestic and foreign financial firms, and caps on equity that can be held by foreign investors in domestic financial firms are gradually raised and done away with. Easier conditions of entry do not automatically increase competition in the conventional sense, since liberalization also involves freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets. This often triggers a process of consolidation.

Thirdly, liberalization involves a reduction in controls over the investments that can be undertaken by financial agents. This can take two forms. Financial agents could be permitted to invest in areas they were not permitted to enter earlier. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to invest in another for fear of conflicts of interest that could affect business practices adversely. Financial liberalization involves the breaking down of the regulatory walls separating these sectors, leading in the final analysis to the emergence of the so-called "universal banks" or financial supermarkets. The consequent ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than they did before.

[5] Non-price competition can also result in a reduction in spreads since it may involve higher costs in the form, for example, of larger investments in a wider Automatic Teller Machine (ATM) network or higher labour costs to provide "relationship banking" services to high value clients.

Further, liberalization also involves the expansion of the sources from and instruments through which firms or financial agents can access funds. This not only leads to the proliferation of instruments such as commercial paper and certificates of deposit issued in the domestic market, but the liberalization of the rules governing the kinds of financial instruments that can be issued and acquired in the system. Financial instruments allow agents to share to differing degrees financial gains and risks, where the gains involved are incomes and asset price appreciation and the risks are, therefore, income and capital risks. These assets can either be issued directly by those looking for capital for productive investments or by intermediaries expecting to obtain a part of the incomes in return for carrying part of the risk.

Fourth, the universalization of banking and the proliferation of financial assets that liberalization involves, transforms the traditional role of the banking system of being the principal intermediary bearing risks in the system. It played this role by accepting relatively small individual liabilities of short maturities that were highly liquid and involved low income and capital risk and made large, relatively illiquid and risky investments of longer maturities. The protection afforded to the banking system and strong regulatory constraints on it were meant to ensure its viability given the role it played.

The way that role is transformed is captured, for example, in the following description of the bank in today's more liberalised financial system: "There was a time when a bank would lend to a business or provide a mortgage, would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return. Times have changed. Banks now take those assets, structure them into pools, and sell securities based on those pools to institutional investors and portfolio managers. In effect, they use their balance sheets not as museums, but as parking lots – temporary holding spaces to bundle up assets and sell them to those investors who have a far greater interest in holding those assets for the long term. " (OECD, 2000: 8). Thus, liberalisation triggers a shift in the role of the "pure" banking system as the principal bearer of financial risk to one where its focus is that of generating financial assets that transfer risks to the portfolio of institutions willing to hold them.

Fifth, liberalisation involves the withdrawal of the state from the activity of financial intermediation with the conversion of the "development banks" into regular banks and the privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital. In India, for example, all three major development financial institutions (the Industrial Finance Corporation of India, the Industrial Development Bank of India and the Industrial Credit and Investment Corporation of India) have been or are being dismantled, converted into multi-purpose banks and privatised.

Finally, financial liberalization eases conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries such as brokers and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market.

Homogenisation of financial sectors

Financial liberalization of this kind being adopted in India not only results in changes in the mode of functioning and regulation of the financial sector, but a process of institutional change. There are a number of implications of this process of institutional change. First, it implies that the role played by the pre-existing financial structure, characterised by the presence of state-owned financial institutions and banks, is substantially altered. In particular, the practice of directing credit to specific sectors at differential interest rates is undermined by reduction in the degree of pre-emption of credit through imposition of sectoral targets and by the use of state banking and development banking institutions as instruments for mobilising savings and directing credit to priority sectors at low real interest rates. The role of the financial system as an instrument for allocating credit and redistributing assets and incomes is also thereby undermined.

Second, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets of the kind referred to above, the liberalization process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system.

Third, it allows for a process of segment-wise and systemic consolidation of the financial system, with the emergence of larger financial units and a growing role for foreign firms in the domestic financial market. This does mean that the implications of failure of individual financial agents for the rest of the financial system is so large that the government is forced to intervene when wrong judgments or financial malpractice results in the threat of closure of financial firms.

Institutional change and financial fragility

The above developments unleash a dynamic that endows the financial system with a poorly regulated, oligopolistic structure, which could increase the fragility of the system. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure.

Financial markets left to themselves are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process (Stiglitz 1994, Rodrik 1998). They are characterised by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing money and time in acquiring information about managements, hoping that others would do so instead and knowing that all shareholders, including themselves, benefit from the information garnered. As a result there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the "herd instinct" characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where market-driven players take on unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

Implications for the real economy

These kinds of tendencies effect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, induce distress sales of assets and result in deflation, all of which adversely impacts on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

The point is that while financial liberalization leads to these kinds of macroeconomic risks, the evidence suggests that the expected microeconomic gains are not really realised. Even in the US, the role of stock markets as a source of capital was limited. Between 1970 and 1989, the ratio of profit retention, bank finance and bonds to the net sources of finance of non-financial corporations in the US amounted to 91.3, 16.6 and 17.1 per cent respectively. The contribution of equity was a negative 8.8 per cent. The first two of these sources played an overwhelming role even in the U.K. and Germany during this period. (Stiglitz 1994). Thus bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In India too the new issues market is small or non-existent expect in periods of a speculative boom, and bank lending post-liberalisation privileges risky high-return investment rather than investment in the commodity producing sectors like manufacturing and agriculture. The effects on those sectors of liberalisation is indirect, being realised through the demand generating effects of housing and personal finance booms, which too in many circumstances tends to increase the fragility of the system.

The capital inflow effects of financial liberalization only aggravate these consequences of the institutional change component of the process. It does not just increase liquidity and permit access to funds that can be played with, it brings in players more adept at dealing with the opportunities offered by the new financial context. When the potential of financial failure becomes or threatens to become a reality, the funds dry up and capital flight occurs, increasing the intensity of the ensuing crisis.

The institutional change associated with financial liberalization not merely increases financial fragility. It also dismantles financial structures that are crucial for economic growth. The relationship between financial structure, financial growth and overall economic development is indeed complex. The growth of output and employment in the commodity producing sectors depends on investment that expands capital stock. Traditionally, development theory had emphasized the role of such investment. It argued, correctly, that given production conditions, a rise in the rate of real capital formation leading to an acceleration of the rate of physical accumulation, is at the core of the development process. Associated with any trajectory of growth predicated on a certain rate of investment is, of course, a composition or allocation of investment needed to realise that rate of growth given a certain access to foreign exchange.

If, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, the government seeks to direct credit to certain sectors and agents and influence the prices at which such credit is provided, it must impose restrictions on the financial sector. The state must use the financial system as a means to direct investment to sectors and technologies it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory. Stated otherwise, although financial policies may not help directly increase the rate of savings and ensure that the available *ex ante* savings are invested, they can be used to influence the pattern of investment.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure – the mix of contracts/instruments, markets and institutions – is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. By dismantling these structures financial liberalisation destroys an important instrument that historically evolved in late industrialisers to deal with the difficulties of ensuring growth through the diversification of production structures that international inequality generates. This implies that financial liberalisation is likely to have depressing effects on growth through means other than just the deflationary bias it introduces into countries opting for such liberalization.

Indian Banking in transition

The fact that such structures are being dismantled is illustrated by the transition in Indian banking driven by a change in the financial and banking policy regime of the kind described earlier. As a result, as noted earlier, banks are increasingly reluctant to play their traditional role as agents who carry risks in return for a margin defined broadly by the spread between deposit and lending rates. Given the crucial role of intermediation conventionally reserved for the banking system, the regulatory framework which had the central bank at its apex, sought to protect the banking system from possible fragility and failure. That protective framework across the globe involved regulating interest rates, providing for deposit insurance and limiting the areas of activity and the investments undertaken by the banking system. The understanding was that banks should not divert household savings placed in their care to risky investments promising high returns. In developing countries, the interventionist framework also had developmental objectives and involved measures to direct credit to what were “priority” sectors in the government’s view.

In India, this process was facilitated by the nationalization of leading banks in the late 1960s, since it would have been difficult to convince private players with a choice of investing in more lucrative activities to take to a risky activity like rural banking where returns were regulated. Nationalization was therefore in keeping with a banking policy that implied pre-empting banking resources for the government through mechanisms like the statutory liquidity ratio (SLR), which defined the proportion of deposits that need to be diverted to holding specified government securities, as well as for priority sectors through the imposition of lending targets. An obvious corollary is that if the government gradually denationalizes the banking system, its ability to continue with policies of directed credit and differential interest rates would be substantially undermined.

"Denationalization", which takes the form of both easing the entry of domestic and foreign players as well as the disinvestment of equity in private sector banks, forces a change in banking practices in two ways. First, private players would be unsatisfied with returns that are available within a regulated framework, so that the government and the central bank would have to dilute or dismantle these regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee-based activities.

In sum, the processes of liberalization noted above fundamentally alter the terrain of operation of the banks. Their immediate impact is visible in a shift in the focus of bank activities away from facilitating commodity production and investment to lubricating trade, financing house construction and promoting personal consumption.

But there are changes also in the areas of operation of the banks, with banking entities not only creating or linking up with insurance companies, say, but also entering into other "sensitive" markets like the stock and real estate markets. The exposure of banks to the stock market occurs in three forms. First, it takes the form of direct investment in shares, in which case, the impact of stock price fluctuations directly impinge on the value of the banks' assets. Second, it takes the form of advances against shares, to both individuals and stock brokers. Any fall in stock market indices reduces, in the first instance, the value of the collateral. It could also undermine the ability of the borrower to clear his dues. To cover the risk involved in such activity banks stipulate a margin, between the value of the collateral and the amounts advanced, set largely according to their discretion. Third, it takes the form of "non-fund based" facilities, particularly guarantees to brokers, which renders the bank liable in case the broking entity does not fulfil its obligation.

The effects of this on bank fragility become clear from the role of banks in the periodic scams in the stock market since the early 1990s, the crisis in the cooperative banking sector and the enforced closure-cum-merger of banks such as Nedungadi Bank and Global Trust Bank. However, the evidence on the relationship between a large number of banks and scam-tainted brokers such as Harshad Mehta and Ketan Parekh only begins to reveal what even the RBI has described as "the unethical nexus" emerging between some inter-connected stock broking entities and promoters/managers of banks. The problem clearly runs deep and has been generated in part by the inter-connectedness, the thirst for quick and high profits and the inadequately stringent and laxly implemented regulation that financial liberalization breeds.

Changes in Banking Practices

Financial reforms have also resulted in a disturbing decline in credit provision (Shetty 2004, Chandrasekhar and Ray 2005). Following the reforms, the credit deposit ratio of commercial banks as a whole declined substantially from 65.2 per cent in 1990-91 to 49.9 per cent in 2003-4 (Table 2), despite a substantial increase in the loanable funds base of banks through periodic reductions in the CRR and SLR by the RBI starting in 1992. It could, of course, be argued that this may have been the result of a decline in demand for credit from creditworthy borrowers in the system. However, three facts appear to question that argument. The first is that the decrease in the credit deposit ratio has been accompanied by a corresponding increase in the proportion of risk free government securities in the banks major earning assets i.e. loans and advances, and investments. Table 2 reveals that the investment in government securities as a percentage of total earning assets for the commercial banking system as a whole was 26.13 per cent in 1990-91. But it increased to 32.4 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities that were offering relatively high, near risk-free returns.

Table 2: Credit Deposit Ratio and Investment in Government Securities as percentage of Total Earning Assets during 1990-91 to 2003-04 (For scheduled commercial banks)

Year	Credit Deposit Ratio	Investment in Govt. Securities (as percentage to total earning assets)
1990-91	65.2	26.13
1991-92	60.6	29.06
1992-93	58.9	29.47
1993-94	55.5	34.08
1994-95	61.6	32.61
1995-96	58.2	31.57
1996-97	55.1	33.88
1997-98	53.5	34.4
1998-99	51.7	33.8
1999-00	53.6	33.4
2000-01	53.1	33.2
2001-02	53.4	28.1
2002-03	78.6	31.6

2003-04	49.9	32.4

<u>Source:</u> Estimated from various issues of Indian Banks' Association, *Performance Highlights of Banks in India*, and Reserve Bank of India, *Report on Trend and Progress of Banking in India*.

Second, under pressure to restructure their asset base by reducing non-performing assets, public sector banks may have been reluctant to take on even slightly risky private sector exposure that could damage their restructuring effort. This possibly explains the fact that the share of public sector banks in 2002-3 in total investments in government securities of the scheduled commercial banks was very high (79.17 per cent), when compared with other sub-groups like Indian private banks (13.41 per cent), foreign banks (5.7 per cent) and RRBs (1.74 per cent).[6]

Finally, with all banks now being allowed greater choice in terms of investments, including corporate commercial paper and equity, even private banks in search of higher profitability would have preferred investments rather than lending. The observed rise in investments by banks would be partly due to bank preference for credit substitutes.

Neoliberal Banking Reform and Credit Delivery

Neoliberal banking reform has also adversely affected the pattern of credit delivery. Since 1991 there has been a reversal of the trends in the ratio of directed credit to total bank credit and the proportion thereof going to the agricultural sector, even though there has been no known formal decision by government on this score. Thus, during the period 2001-04, the total outstanding credit to the agricultural sector extended even by public sector banks was within the range of 15-16 per cent of net bank credit (NBC) as against the target of 18.0 per. Though in respect of private sector banks, the ratio of agricultural credit to NBC increased from 7.1 per cent to 11.8 per cent, it still was below target (Reserve Bank of India 2005).

According to a study undertaken by the EPW Research Foundation (Shetty 2004) relating to the period 1972 to 2003, the share of agriculture in total bank credit had steadily increased under impulse of bank nationalization and reached 18 per cent towards the end of the 1980s. But, thereafter, the trend has been a reversed and the share of the agricultural sector in credit has dipped to less than 10 per cent in the late 1990s—a ratio that had prevailed in the early 1970s. Even the number of farm loan accounts with scheduled commercials banks has declined in absolute terms from 27.74 million in March 1992 to 20.84 million in March 2003.

Similarly, the share of small-scale industry accounts and their loan amounts in total bank loans has fallen equally drastically. The number of accounts has dropped from 2.18 million in March 1992 to 1.43 million in March 2003, and the amount of credit as a percentage of the total has slumped from 12 per cent to 5 per cent, that is, less than one-half of what it was three decades ago, that is, in the early 1970s.

At the same time, serious attempts have been made in recent years to dilute the norms of whatever remains of priority sector bank lending. While the authorities have allowed the target for priority sector lending to remain unchanged, they have widened to include

[6] Bank group-wise Liabilities and Assets of scheduled commercial banks in Reserve Bank of India, *Statistical Tables relating to Banks in India, 2002-3*, Mumbai: RBI.

financing of distribution of inputs for agriculture and allied sectors such as dairy, poultry and piggery and short-term advances to traditional plantations including tea, coffee, rubber, and spices, irrespective of the size of the holdings.

Apart from this, there were also totally new areas under the umbrella of priority sector for the purpose of bank lending (Reserve Bank of India 2005). In 1995-96, the Rural Infrastructural Development Fund (RIDF) was set up within NABARD and it was to start its operation with an initial corpus of Rs. 2000 crore. Public sector banks were asked to contribute to the fund an amount equivalent to their short fall in priority sector lending, subject to maximum of 1.5 per cent of their net credit. Public sector banks falling short of priority targets were asked to provide Rs. 1000 crore on a consortium basis to the Khadi and Village Industries Commission (KVIC) over and above what banks were lending to handloom co-operatives and the total amount contributed by each bank was to be treated as priority sector lending. The outcome of these new policy guidelines could not but be that banks defaulting in meeting the priority sector sub-target of 18 per cent of net credit to agriculture, would make good the deficiency by contributing to RIDF and the consortium fund of KVIC.

Another method to avoid channelling of credit to priority sectors has been to ask banks to make investments in special bonds issued by certain specialised institutions and treat such investments as priority sector advances. In 1996, for example, the RBI asked the banks to invest in State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), NABARD and the National Housing Bank (NHB). These changes were obviously meant to enable the banks to move away from the responsibility of directly lending to the priority sectors of the economy. Yet, special targets for the principal priority areas have been missed.

The most disconcerting trend was the sharp rise in the role of the "other priority sector" in total priority sector lending. This sector includes: loans up to Rs. 15 lakh in rural/ semi-urban areas, urban and metropolitan areas for construction of houses by individuals; investment by banks in mortgage backed securities, provided they satisfy conditions such as their being pooled assets in respect of direct housing loans that are eligible for priority sector lending or are securitised loans originated by the housing finance companies/banks; and loans to software units with credit limit up to Rs. 1 crore. Not surprisingly, the ratio of "other priority sector" lending to net bank credit rose from 7.4 per cent in 1995 to 17.4 per cent in 2005.

The net effect of all this was that the share of direct finance to agriculture in total agricultural credit declined from 88.2 per cent in 1995 to 71.3 percent in 2004. The share of credit for distribution of fertilizers and other inputs which was at 2.2 per cent in 1995 increased to 4.2 per cent in 2004 and the share of other types of indirect finance from 4.8 per cent to 21.0 per cent. Further, credit to the SSI sector as a percentage of NBC declined from 13.8 per cent to 8.2 per cent. Much of this credit went to larger SSI units, as suggested by the fact that the number of SSI accounts availing of banking finance declined from 29.6 lakh to 18.1 lakh.

In sum, the principal mechanism of directed credit to the priority sector that aimed at using the banking system as a instrumentality for development is increasingly proving to be a casualty of the reform effort.

Impact on Development Banking

Besides adversely affecting rural income and employment growth, the reforms can be expected to impact adversely on private investment by damaging the structure of development banking itself. On March 30 2002, the Industrial Credit and Investment Corporation of India (ICICI) was, through a reverse merger, integrated with ICICI Bank. That was the beginning of a process that is leading to the demise of development finance in the country. The reverse merger was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a universal bank that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

Since the announcement of that decision, not only has the merger been put through, but similar moves are underway to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February 2004, Finance Minister Jaswant Singh, announced the government's decision to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board approved the proposal, rendering itself defunct.

Finally, the Parliament approved the corporatisation of the IDBI, paving the way for its merger with a bank as well. IDBI had earlier set up IDBI Bank as a subsidiary. However, the process of restructuring IDBI has involved converting the IDBI Bank into a stand alone bank, through the sale of IDBI's stake in the institution. Now IDBI has been merged woth IDBI bank. With this creation of a universal bank as a new entity, that has multiple interests and a strong emphasis on commercial profits, it is unclear how the development banking commitment can be met.

These developments on the development banking front do herald a new era. An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes, was the creation of special development banks with the mandate to provide adequate, even subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by Eshag (1983), there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer, the remainder had a mixed ownership or were private. Mixed and private banks were given government subsidies to enable them to earn a normal rate of profit.

The principal motivation for the creation of such financial institutions was to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

Conclusion

In sum, the Indian experience indicates that, *inter alia*, there are three important outcomes of financial liberalisation First, increased financial fragility, which the irrational boom in India' stock market epitomises. Second, a deflationary macroeconomic stance, which adversely affects public capital formation and the objectives of promoting employment and reducing poverty. Finally, a credit squeeze for the commodity producing sectors and a decline in credit delivery to rural India and small scale industry. The belief that the financial deepening that results from liberalisation would in myriad way neutralise these effects has not been realised.

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