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A hallmark of India's new economic policy: deregulation and liberalization of the financial sector

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Abstract

A fundamental job of the financial sector of any economy is to allocate capital efficiently. To achieve this, capital is supposed to be invested in the sectors that are expected to have high returns and be withdrawn from sectors with poor prospects. The purpose of this paper is to ascertain the validity of this proposition in the context of financial liberalization in India. We first examine whether the total funds (debt and equity) available for investment started flowing to the "more efficient" (defined later), Indian firms due to financial liberalization. We examine changes in the allocation of credit across industrial sectors and changes in the allocation of capital among firms within the same sector or industry. Our empirical analysis shows that during the early years of financial liberalization the share of investment going to the more efficient firms did not rise, resulting in no perceptible rise in the overall efficiency of investment allocation for the economy. Our analysis of the sources and uses of funds shows that in the period immediately following the announcement of liberalization in 1991, there was a tendency in the Indian corporate sector towards a myopic use of funds. The surge in the availability of funds in the stock market, coming mainly from small and medium savers, failed to translate itself into any noticeable rise in gross fixed assets (GFAs). Thus, the lack of an improvement in the index of efficiency of investment allocation can be partly ascribed to bad investments to begin with. The message that emerges is that financial reforms in an inadequate regulatory framework do not necessarily have positive effects. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

A fundamental job of the financial sector of any economy is to allocate capital efficiently. To achieve this, capital is supposed to be invested in the sectors that are expected to have high returns and be withdrawn from sectors with poor prospects. It has been argued that formal financial markets and associated institutions improve the capital allocation process and thus contribute to economic growth. However, there is little actual evidence on whether and how financial markets improve the allocation of capital. Recently, Wurgler (2000), using a data set comprising 65 countries and 28 industries over 33 years finds that developed financial markets, as measured by the size of the domestic stock and credit markets relative to GDP, are associated with a better allocation of capital. Financially developed countries increase investment more in their growing industries and decrease investment more in their declining industries. Thus, although financially developed countries might not invest at a higher level (Carlin and Mayer, 1998; Beck et al., 2000), they do seem to allocate their investment better. For example, the elasticity of industry investment to value added is several times higher in Germany, Japan, the United Kingdom, and the United States than in financially undeveloped countries such as Bangladesh, India, Panama, and Turkey. Relative to countries with large financial markets, other countries both overinvest in their declining industries and underinvest in their growing industries.

Wurgler argues that capital allocation is improved through at least three mechanisms. First, countries with stock markets that impound more firm-specific information into individual stock prices exhibit a better allocation of capital. This is consistent with the suggestion that larger markets have more informative prices, which help investors and managers distinguish between good and bad investments. Second, capital allocation improves as state ownership declines. This is not surprising because in state-owned firms, resource allocation is guided less by value-maximization than by political motives. Also, soft budget constraints and poor monitoring give managers in state-owned firms few incentives for efficiency. The existing evidence on this supports the view of Shleifer (1998) that "elimination of politically motivated resource allocation has unquestionably been the principal benefit of privatization around the world." Third, strong minority investor rights, as measured by La Porta et al. (1998), are associated with better capital allocation. The allocational benefit of investor rights seems to come through limiting overinvestment in declining industries rather than through improving the supply of finance to growing industries.

There are other notable contributors to the literature on the relationship between finance and economic growth. At the country level, King and Levine (1993), Levine (1998), Levine and Zervos (1998), and Beck et al. (2000) make an empirical case that financial development causes growth. At the industry level, Rajan and Zingales (1998) show that the industries that rely on external financing in the United States grow faster in financially developed countries. Arguably, these are industries with a technological need for external finance, perhaps to reach an efficient scale. At the United States state level, Jayaratne and Strahan (1996) find that economic growth increases in states that relax intrastate bank branching restrictions. At the firm level, Demirguc–Kunt and Maksimovic (1998) use a financial planning model to estimate sustainable growth rates in the absence of external finance and find that firms in financially developed countries are able to grow faster than this benchmark.