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India as an Emerging Financial Market: Pre and Post Liberalization Scenario

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ABSTRACT:

India is presently one of the fastest growing nations in the world. Since the liberalization in the early 1990's, India has proficient nothing short of an economic revolution to become an emerging global economy. An emerging financial market is where a lot of opportunities are available and the market has great potential, but not the capital to achieve it. If capital is infused, a lot of growth is possible. That is exactly what has happened in India since the liberalization in 1991. A lot of money has been flowing into the country from the developed countries. With the stock market tripling in the last 10 years, significant foreign portfolio inflows, including private equity inflows, and a rapidly developing derivative market, the Indian financial system is witnessing an exciting era of transformation.

This has also given rise to some very powerful growth stories in the financial services industry. New entrepreneurs in the financial services industry have emerged and within 10-15 years they have become billionaires.

The paper has an attempt to discuss the performance of India in the financial sector in the past two decades. It also analyses the various steps taken to attract new capital into the country in the Post liberalization period.

Key Words: Financial Reforms, Liberalization, Banking Sector, NBFC, Capital Market

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1. INTRODUCTION:

The history of India's economic growth is divided into two phases, the first 43 years (1947-1990) after independence featuring measures of socialism, and the last twenty three years (1991-2013) as a free market economy. During the first 43 years after independence, the government controlled most of the consumer services, and coupled with regulation in the manufacturing sector, India witnessed limited growth. The first three decades of India's policy formulation were marked by socialist policies. Between 1950 and 1980 India grew at an annual rate of 3 to 3.5 percent, which was also referred to as the "Hindu rate of growth." But 1991 saw the nation enter into a new phase of economic policies. For the first time India saw a shift away from its socialist ideologies. The impetus for these reforms started in 1980s when Rajiv Gandhi became the Prime Minister and brought some macro-economic changes.

Following the reforms in 1991, the Indian economy has enjoyed a strong capital growth with annual GDP growth exceeding 8 percent since 2003. Private investments have grown extremely fast and constituted 80 percent of the total investments in 2010-11. The poverty ratio went down from 45 percent in 1992-93 to 32 percent in 2009-10. This growth has been accompanied by some structural changes. The share of services in total GDP jumped from 43 percent in 1990-91 to 58 percent in 2010-11, while that of agriculture slipped to 14 percent in 2010-11 from 28 percent in 1990-91. There has been a paradigm shift in the configuration of the economy resulting in increased importance of external trade, foreign capital inflows, and growth of the domestic capital market. In addition, the new liberalization era has convinced the world's investors that India holds great economic promise. The result has been that since liberalization the Indian capital market has been one of the best performing markets in the world. In the past 10 years the stock market has more than tripled in value fuelled by strong economic growth and large inflows from foreign institutional investors.

In India, due to socialistic policies of the Government, there were a lot of constraints in the financial markets and hence the development of financial markets was delayed. But once liberalization took place in 1991, reforms took place and the financial markets developed. This

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directly led to a boost in economic development of the country and it fell in line with the past researches that financial market development precedes economic development and also that financial sector development spurs economic development.

2. OBJECTIVES:

1. To study the reforms of the financial sector in the Pre and Post Liberalization period.
2. To analyze the steps taken by the Government to reinforce the economy after Post Liberalization scenario.
3. To examine the development in the financial market which leads to the economic growth of the country.

3. DISCUSSION:

3.1 STEP TAKEN TO LIBERALIZATION:

During this time, Prime Minister P.V. Narasimha Rao and his finance minister (later, India's Prime Minister) Manmohan Singh undertook bold measures to turn around the situation. On 1 and 3 July 1991, Prime Minister Narasimha Rao's government devalued the rupee in two steps and promised to make the currency convertible within three to five years. Major reforms in trade policy were also made soon after. Twenty days later, the asset limit (firms with assets of more than 100 crores, ~USD 16.6 million, had to take permission from the government to function and were called monopolies) for firms listed under the Monopolies and Restrictive Trade Practices Act was scrapped, along with industrial licensing for most projects, and the foreign equity limit was raised to 51 percent. The industrial policy was announced the same day that the union budget was presented in Parliament. In the annual budgets that followed, additional measures were taken to reduce the fiscal deficit, including divestment in state owned enterprises, promotion of foreign direct investment, and private sector participation in infrastructure (core) sectors like power, telecommunications, and roads. In addition, the measures included abolition of import controls through licensing for capital goods, the reduction across the board of all import duties, and the liberalization of gold and silver imports. Divestment of up to 49 percent was allowed in select public sector enterprises, support was to be withdrawn from loss-making units, and a National Renewal Fund was announced to help workers affected by industrial restructuring. Following are some of the positive effects of the reforms:

- Focus on globalization & opening up of the economy
- Thrust on export led growth
- Deregulation to encourage capital inflows
- Integrate with international financial markets
- Lowering of tariff barriers and liberalized imports
- Full convertibility of the rupee on current account
- Permitting domestic companies to access foreign capital markets
- Substantial liberalization of restrictions on foreign investment

3.2 PRE-LIBERALIZATION SCENARIO:

After independence, India was under immense financial hardships. Especially in the 1950's and 1960's India saw a number of bank failures. The private commercial banks were unable to fulfill the social and development goals of banking. Hence, to better align the banking system to the needs of the economic policy in India, the Government of India issued an ordinance in 1969, which led to the nationalization of India's 14 largest commercial banks. This event shaped the philosophy of financial sector reforms over the next 15 years. Successively, in 1972 the insurance sector was nationalized. By 1980, six more banks had been nationalized by the Government of India controlling almost 91 percent of the banking business in India. Nationalization enabled the banking system to quickly expand in the rural areas. Population per bank office came down from 65,000 in 1969 to 14,000 in 1990. Increased branches also gave rise to higher domestic savings.

In terms of financial markets, the bond market and FOREX market were limited. The call money rate was controlled. But the stock market was an exception as India had one of the oldest stock exchanges in Asia, the Bombay Stock Exchange (BSE). Yet it also had a lot of controls on the floatation of new issues by the Controller of Capital Issues (COCI).

Finally, India's economic model was based on the policy of "self-reliance". Hence, most of the investments were financed by domestic savings and there was reluctance to permit foreign investments. In 1990-91 when trade imbalances were accompanied by a fall in private remittances, the current account deficit widened to 3.2 percent of the GDP. With the Gulf crisis happening at the same time, capital inflows dried up and India pledged gold to the Bank of England to escape a default.

Overall by1991, the government had built up a big banking network, boosting growth and savings, but also giving rise to numerous problems and inefficiencies. Based on government policies the nationalized banks gave enormous loans to small-scale industries and sectors such as agriculture. However, banks struggled to recover loans and non-performing loans increased. Labour productivity and efficiency came down. It was clear that the financial sector needed to be liberalized for a higher growth trajectory.

3.3 POST LIBERALIZATION SCENARIO: DEVELOPMENTOF INDIA'S FINANCIAL MARKETS:

With liberalization taking place in early 1990's, India's financial markets began their transformation path. Financial liberalization was part of greater reliance on the private sector after the 1991 foreign exchange crisis. After the 1991 capital markets crisis, regulations were strengthened, listings were liberalized, foreign investors were allowed in, and infrastructure was substantially improved. (Shah and Thomas 1999; Nayak 1999)

A: BANKING REFORMS: Banking reforms came in two sets, both chaired by M. Narasihman. The first report: Narasihman Committee I took place in 1991 and was primarily devoted to giving operational freedom to banks. The second report came in 1998 and was called Narasihman Committee II, which focused on stability issues and prudential regulations. Some important reforms in banking are discussed below.

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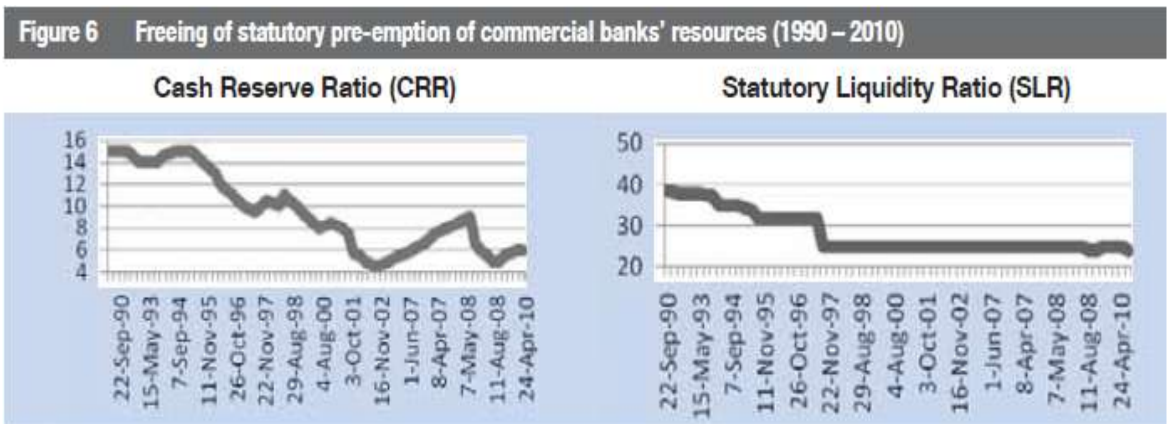
1. *Interest Rate Deregulation*: Complete deregulation culminated by October 1994 and a system of prime lending rate was introduced. It brought in a lot of transparency in lending rates.
2. *Reduction in Statutory Pre-emption*: Both the Capital Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) were reduced. By August 2003 the CRR rate had come down to 4.5 percent and by October 1997, the SLR had already been reduced to its minimum level of 25 percent. The SLR is seen as a genuine tool to ensure safety of the banking system.

Figure 3.1: Reduction in Cash Reserve Ratio and Statutory Liquidity Ratio after reforms



Source: RBI (2011): *Handbook of Statistics on Indian Economy.*

3. *Ownership Structure and opening up to private sector*: The Indian banking sector opened up to private bank formations in 1993 and 10 new bank licenses were given to them. The public-sector banks were also allowed to raise money from the market by issue of equity as long as they maintained 51 percent public ownership.

The reforms brought significant changes in the Indian banking system. The most important was increased competition amongst banks due to entry of new domestic and foreign banks. This directly led to reduction in Non-Performing Loans (NPLs). The ratio of NPL to total advances declined from 15.7 percent in 1996-97 to only 2.4 percent in 2009-10.Also, the operating cost per unit of earning assets (unit cost of output) fell from 2.08 percent in 1992 to 1.78 percent in 2004.Overall, profitability for commercial banks saw a huge increase.

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Figure 3.2: Decline in Non-Performing Assets of Banks since reforms

Table 2 Non-performing loans (per cent of total advances)

Year	Public	Old private	New private	Foreign
1994	24.8	–	–	–
1995	19.5	–	–	–
1996	18	–	–	–
1997	17.8	10.7	2.6	4.3
1998	16	10.9	3.5	6.4
1999	15.9	13.1	6.2	7.6
2000	14	10.8	4.1	7
2001	12.4	10.9	5.1	6.8
2002	11.1	11	8.9	5.4
2003	9.4	8.9	6.7	5.3
2004	7.8	7.6	5	4.6
2005	5.5	6	3.6	2.8
...	...	...	...	...
2009	1.97	2.36	3.05	3.8
2010	2.19	2.32	2.87	4.29

B: REFORMS IN THE CAPITAL MARKETS:

Some sweeping reforms led to spectacular growth in in the capital markets. There were increases in capital raised from the market, the number of stocks listed, the investor population, and most importantly technological sophistication leading to improved transparency and efficiency. Following are some of the important reforms that contributed to the capital market boom in India.

1. *Market Pricing of Issues*: The office of the Controller of Capital Issues (COCI) was abolished, which removed the administrative controls over the pricing of new equity issues. Pricing was left to the market. This facilitated better price discovery.
2. *Creation of the Regulatory Bodies*: The Securities and Exchange Board of India (SEBI) were empowered in 1992. It was created to protect the interests of investors and promote the development of the securities market. With the setting up of SEBI all market intermediaries

are supposed to be registered with SEBI, which also sets down the guidelines for Disclosure and Investor Protection. This enabled transparency in the capital markets and built trust in the investors, playing a very important role in increasing the capital raised by companies from the markets. In addition, the establishment of the National Securities Clearing Corporation (NSCC) in 1996 removed the problem of counter-party risk as it guaranteed each trade.

3. *Open Electronic Limit Order Book Market*: A major reform was introduced in 1994 when National Stock Exchange (NSE) started Electronic Limit Order Book (ELOB) and screen-based trading. It was followed by the Bombay Stock Exchange (BSE) in 1995. This enabled much higher liquidity and facilitated transparent screen-based trading, as the open outcry method earlier was dominated by the traders at BSE. This also paved way for nationwide connectivity. As the ELOB was based on a computer-based matching system, it integrated the nationwide markets, reducing the price variations between markets. Orders placed from any part of the country by a computer could be matched with any order from any part of the country, thus reducing arbitrage opportunities. It enabled the market to become more efficient and reduced transaction cost.

4. *Depository Services:* With lack of technology, share transfers till 1996 required physical movement of share certificates. To sell the stock the shareholders had to send certificates to the company through post offices. This resulted in a lot of back office work and increased transaction costs. Also to get the shares transferred it took up to 45 days, adversely affecting the stock liquidity. But with the passing of the Depository Act in 1996, depositories were allowed to dematerialize securities and convert physical securities into electronic form. The depositors were also supposed to electronically record who owned the stock. This directly reduced transaction and handling costs, while also reducing the possibility of forgery and counterfeiting. Liquidity improved and contributed to market efficiency. India currently has two depositories: National Securities Depository Limited (NSDL) and the Central Depository Services Limited (CDSL).

5. *Derivatives Trading*: One of the most important reforms took place in June 2000 with the introduction of exchange-traded derivative instruments. Instruments such as futures and

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Options enabled investors to better hedge their positions and provided them with better risk management.

6. *Capital from Abroad*: In 1994 Indian companies was given access to raise capital from abroad using Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). Hence, the corporate capital formation was available from domestic savings as well as from foreign savings.
7. *Foreign Portfolio Investment:* Another landmark reform that took place in 1993 was the opening up of the Indian stock market for foreign portfolio investment and for the first time Foreign Institutional Investors (FIIs) were allowed to invest in the Indian stock market. This was a big boost to the secondary market. It also played a huge role in boosting India's foreign exchange reserves, especially at a time when the country's reserves were precarious after the 1991 crisis. In addition, the increase in capital flowing from outside reduced interest rates which had a positive impact on investment and growth.
8. *Corporate Debt*: Before 1991, the corporate debt market was extremely inactive due to control of interest rates and limited issuances. But in May 1992, the interest rate ceiling for corporate bonds was abolished. In addition, SEBI has approved trading of corporate bonds on NSE, BSE and Fixed Income Money Market and Derivatives Association (FIMMDA). Also Foreign Institutional Investors (FII) limit for investment in domestic corporate bonds have been increased to USD 40 billion. However, the corporate debt market is still rather underdeveloped and illiquid.
9. *Other Reforms:* A lot of other reforms also contributed to the boom in capital markets. The mutual fund industry was opened to the private sector. Stock buyback facilities were granted to companies. And most importantly, a lot of risk-management enhancements were put in place.

Overall, after successful implementation of a decade of reforms beginning of 1991, the Indian capital market was transformed dramatically. Following are positive effects of the reforms:

- Substantial improvement in liquidity
- Market-determined pricing

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- Better risk management with possible use of derivatives
- Development of regulatory bodies
- Global integration and integration of markets within the country
- Electronic trading leading to much more efficient and transparent market

Significant growth acceleration took place in the financial services industry in India after these reforms were put in place. The development of the equity capital market took an exponential growth trajectory largely reflecting the approach to the segment of the government. The market index SENSEX more than tripled between 2000 and 2007. Market capitalization increased from less than USD 300 billion to more than USD 1 trillion during this period. The growth was fueled by both the domestic as well as foreign investors. FIIs poured in a lot of money as liberalization allowed them to make higher investments and derivative markets allowed them to hedge risks. The Bombay Stock Exchange became the 11th largest stock exchange in the world by market capitalization as of December 2012.

Figure 3.3: BSE Sensex increases more than threefold between 2004 and 2008

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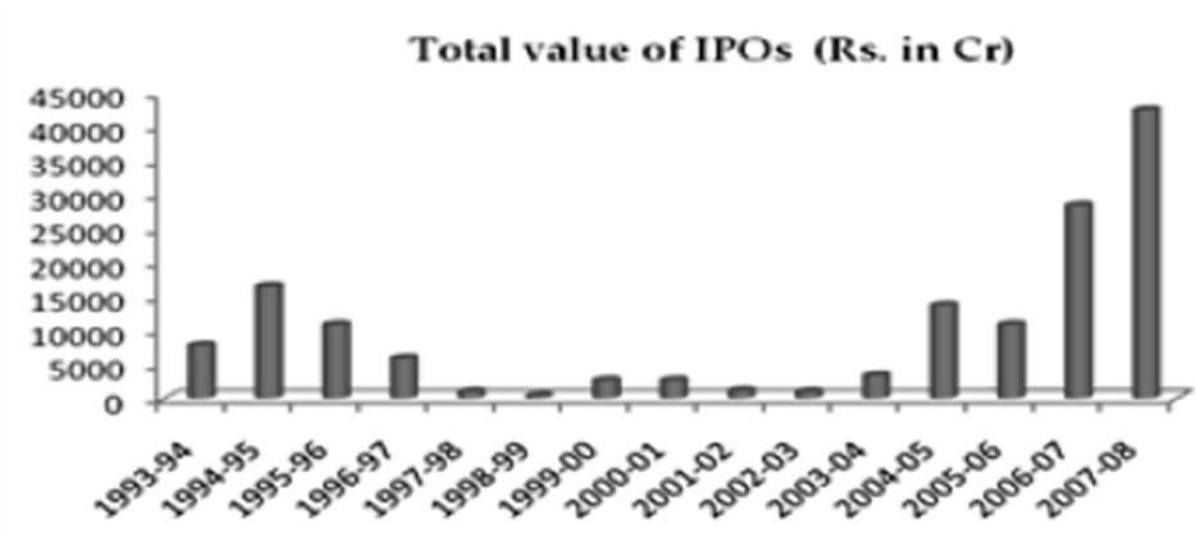
A lot of public companies were privatized during liberalization leading to a surge in IPOs. The primary market suffered during 1995-96 to 2002-03 from scams and corruption, which led to a reduction in demand. But the markets rebounded sharply from 2003-04. The markets saw 139 new public issues during the 2005-06 raising more than Rs. 23,000 crores (~ USD 4 billion). By 2007-08 the collection had gone up to Rs. 42,595 crores (~USD 7 billion). The years 2008 and 2009 were tough for the market due to the global credit crunch, but 2010 not only saw the revival of the Indian primary market but also set new records. A record Rs. 71,114 crores (~USD 12 billion) were raised via public issues. In addition, capital raised through private placement went up more than 20 times from Rs. 15,066 crores (~USD 2.5 billion) in 1997-98 to Rs. 342,445 crores (~ USD 56 billion) in 2009-10. Currently, more than 5,000 companies are listed on the Bombay Stock Exchange.

Figure 3.4: Total Value of IPOs in India since 1993



Overall, the Indian financial markets saw robust growth as they integrated with international markets; more sophisticated risk management tools were developed, and as the markets became more transparent. The annual turnover, market capitalization, and the BSE Sensex saw sharp increases since 1991.The market was driven by FII inflows, improved corporate performance,

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sound macro-economic fundamentals, and upgrading of India's credit ratings by international credit rating institutions. On 30 October 2006, the BSE Sensex had joined the club of global indices above 10,000, and by 2008 the Sensex was trading above 21000.

Figure 3.5: Effect of Reforms: Average Daily turnover in National Stock Exchange

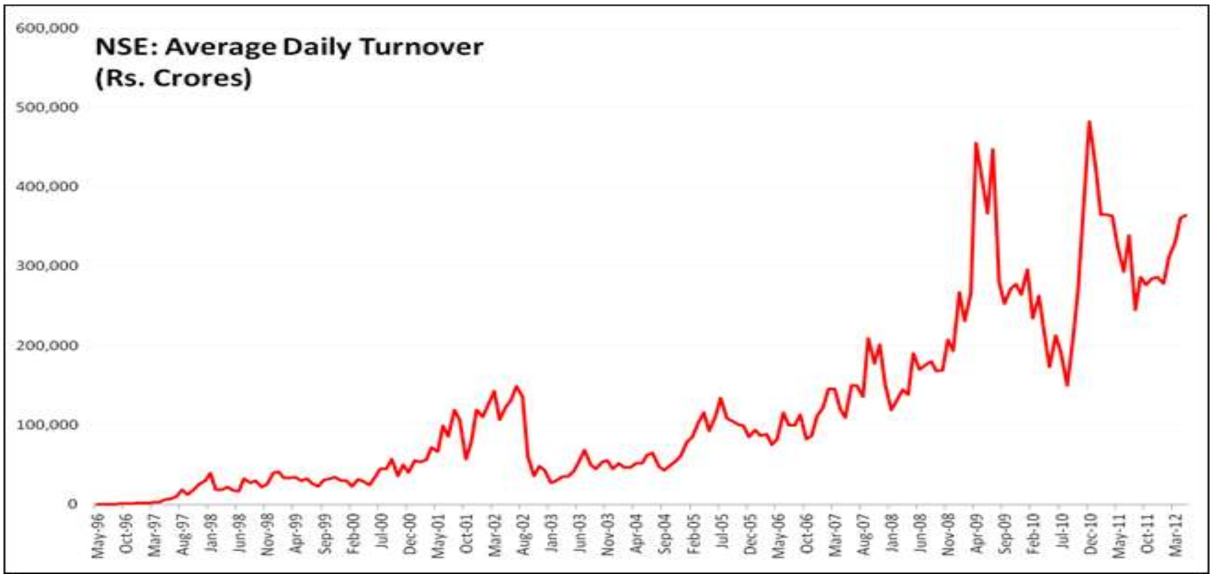

Figure 3.6: Effect of Reforms: Number of Trades on National Stock Exchange reaches

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C: OTHER FINANCIAL INSTITUTION AND NBFC

Apart from reforms in the banking sector and capital markets sector, other areas in the financial services industry also saw reforms. The mutual fund industry in India had started in 1963 with the formation of UTI, an initiative of the Government of India and Reserve Bank of India. Till 1987, UTI was the only mutual fund. However, in 1993, the private sector got clearance for mutual funds. In addition, the government allowed foreign institutional investors in the mutual fund segment. Since then the mutual fund industry has seen an explosion of funds flowing in the industry. As new financial institutions opened up in the late 1990s and offered schemes with high returns, the assets under management of mutual funds ballooned from Rs. 85,822 crores (~ USD 14 billion) in 1997 to Rs. 5.05 lakh crores (~ USD 83 billion) in 2008.

The insurance sector saw similar growth. In 1993, the Government set up a committee under the chairmanship of former RBI Governor R.N. Malhotra to reform the insurance sector. In 1994, the committee submitted a report requesting that the private sector be permitted into the insurance industry. In addition, the committee also proposed that foreign companies be allowed to enter the industry, preferably in the form of joint ventures. The law was passed in 2000, and the private sector was allowed to enter the industry. Also, up to 26 percent of foreign equity was allowed (Ahluwalia, 2002). In 2000, an autonomous body, the Insurance Regulatory and Development Authority (IRDA) was set up to regulate and develop the insurance industry. Currently, India has 24 general insurance companies and 23 life insurance companies.

Apart from the above described industries a lot of Development Finance Institutions (DFIs) and Non-Banking Financial Companies (NBFCs) have opened up in India, offering a wide variety of financial services. They play a vital role in providing credit to small borrowers and unorganized sectors at the local level.

4. CONCLUSION:

India's capital market witnessed rapid growth since liberalization in 1991. It is evident that financial sector modernization preceded economic development of India and also that development of financial sector spurred economic growth in the country. Financial liberalization had a positive effect on the economy's saving, investment and efficiency, with a well-functioning stock market playing a major role. This led India to witness extraordinary growth for the next two decades. From 1990 to 2012 India's GDP grew at an average of 6.1 percent, second only to China. Moreover, new opportunities came up as the economy opened up. These were taken up by entrepreneurs, some of them becoming extremely successful.

However, India still has to confront a lot of challenges to sustain rapid economic growth in the long run. This also means that more opportunities will be coming up for entrepreneurs. As the financial sector in India becomes more and more efficient the cost of capital will decrease. Also, as India constantly attracts more and more FDI, India's growth story is expected to continue in the years ahead.

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