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Tracing Some of the Distributional Consequences of Financial Reforms in India: 1991-2005

Abstract

This paper is a chapter from the author's PHD thesis written in 2005. It examines the history of financial reforms in India up to 2005 and the consequences for the distribution of income and wealth. A short appendix provides a very abbreviated discussion of the further changes from 2005-2012.

Key words Financial Reforms, India, Distribution, Wealth, Inequality

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1 Introduction

In March 1991, following a severe crisis emanating from the international sector, the Indian government embarked on a series of reforms meant to turn the Indian economy away from a dirigiste regime towards a more liberalized and globalized system. Successive governments and further liberalization have brought wide ranging changes to all aspects of the economy, including the deregulation of industrial licensing, the dismantling of several areas originally reserved for the public sector, the overhauling of the tax system, the reduction of import tariffs and internal and external financial liberalization.

As might be expected, much has been written about the consequences of reforms, most often with respect to their purely economic outcomes (such as growth and stability) but also with regard to social outcomes such as unemployment, poverty and inequality (see Dutt and Rao 2001 for a brief review of the major studies). Notwithstanding this large and burgeoning literature, at least one prominent gap remains stubbornly understudied. Despite seemingly numerous indications of its relevance for policy makers, there have been few efforts to address the distributional consequences of financial liberalization in the Indian economy as a whole.

This main emphasis of this chapter is aimed therefore at throwing some light on the specific nature of both internal and external financial deregulation in India, and its implications for distribution.. To do this, I focus primarily on three linked but conceptually distinct 'circuits' of finance as mentioned in the introduction, which have been altered by the process of liberalization: the bank based financial circuit, the market based (or capital market based) circuit and the government finance circuit. For the most part, the descriptive analysis is confined to looking at trends before and after the onset of reforms. The 'before/after methodology' is not without problems, specifically because of endogenous and otherwise contemporaneous factors which occur with the changes in question. In order to mitigate these problems of identification, causal mechanisms are considered in each analysis.

There has been mounting concern in India among policy makers and academics (Patnaik, 2001; Ramachandran and Swaminathan, 2005)), on specific issues to do with financial liberalization and distributional outcomes. In particular two areas of concern have been highlighted in their previous research. First, how has financial liberalization impacted the availability of credit to the vulnerable sections of society? Second, how has financial liberalization impacted the fiscal capacity of the state and its ability to make social and development expenditures?

The chapter addresses these questions among others. In the first section, I summarize the changes in the banking system since 1991 to 2005 and focus on their distributional consequences. Analyzing Reserve Bank of India data and using a wide variety of secondary sources, the results show that there has been a significant decrease in credit availability to a large swathe of the Indian public as banks have abandoned their role as agents of development.The following section considers the effects of the scaling back of financial regulations on government revenue and development expenditure. Financial liberalization has been associated with an increased interest burden for the state in the aftermath of a costly run-up in real interest rates in the mid 1990s. A minimal econometric exercise suggests that this has had some effect in reducing development spending. The third section goes on to briefly assess the impacts of financial liberalization in the light of the liberalization-neostructuralist

debate (McKinnon, 1973, Shaw, 1973, Taylor, 1983, Rao, 1995).The next section focuses on the changes in the capital market. Listing the domestic and international changes in the regulatory structure post liberalization the section looks at the concentration of ownership and its distributional effects in the stock market. In the penultimate section considers some of the other distributional effects of financial deregulation: the increasing wage disparity arising from foreign direct investment and the effect on land prices of capital inflows. The last section concludes.

2 Banking Reforms

The evolution of the financial system in independent India can be broadly categorized into three separate periods. The first was a period of relatively unregulated finance between 1947 and 1969 (sometimes called the pre-nationalization era). This was followed by a period of increasing direct intervention between 1969 and 1991 (variously called the era of financial repression, the era of nationalization, or the era of 'social control'). The last and ongoing period, consists of a movement back towards a more market oriented financial system from 1991 (called the era of financial reform).For the purposes of this chapter, I will focus on the last section of the period of social control and the period of reforms in particular.

The period of social control can be said to really date from July 1969, when 14 of the largest Indian scheduled commercial banks were nationalized. This was a direct response of the central government to the perceived non-compliance of private commercial banks in meeting the priorities set out in the post independence period five-year plans (Sen and Vaidya, 1997). The takeover of banks meant that more than four-fifths of the deposits in the Indian economy had come under public control[1] and remained under control for two decades. The consequences wrought by nationalization were deep and abiding, affecting the level and flexibility of interest rates, the volume of resources mobilized, the distribution of credit and the efficiency of the banking sector alike.

Perhaps the most impressive and positive achievement of the nationalized banks was the vast mobilization of deposits achieved by setting up of branches in the rural and semi urban areas of the country in order to facilitate agrarian development. Consequently, the population per bank branch declined significantly across the country in this period from 64,000 people per branch to 15,000 people per branch by 1989 (Sen and Vaidya,1997). As a result of this expansion, the Indian financial system was a great deal deeper than other countries of a similar level of development[2].

In addition to increasing access to finance for all sections of the economy, the nationalized bank system was also put under pressure, both through regulations and informal suasion to increase their lending to sectors which were designated as having priority in the planning

[1]This was later increased to 92 % in 1980 when six more banks were nationalized.

[2]The deposits to GDP ratio in 1989 was over 50%. For purposes of comparison, the average of the Money and quasi money (M2) as % of GDP across the 46 low income countries for which there is data available for 1989 was 21% (source: calculation from World Development Indicators) while India's at 39% was the highest among the countries.

process. Credit in the pre-nationalized period had been clearly skewed towards urban corporate industry, which doubled its share of credit in the system from 34% to 68% in between 1951 and 1968. By contrast, post 1969, there was a concerted effort to provide credit towards those sectors deemed to be crucial to alleviate poverty and to enhance employment, including agriculture, small scale industry, artisans and retail trade. These attempts to direct credit became crystallized over the period through legislation for the 'priority sector lending requirements' for banks. In the late 1970s, banks were directed to reserve 33% of their credit for these priority sectors, an amount which was later to rise to 40% of credit advanced. These priority sector lending requirements have been contentious in the fact that they deviate from standard policy recommendations[3] and despite later recommendations to do away with these, have persisted, albeit with modifications. In addition, the interest rate was administered with varying rates for preferred borrowers.

A central problem in India, as with many other developing economies has been the inability of the government to raise non-distortionary tax revenues in a systematic and efficient way (Khattry, 2002). Given the aversion that the government displayed towards external borrowing (see Nayyar, 2000) and the increasing demands made on its resources in a planned economy, the government turned to the banking sector to provide a source of cheap funds. As a result, nationalized banks and scheduled commercial banks were used systematically to subsidize government spending through the mechanism of the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR). Over the period, the government raised the SLR as a way by which to ensure that banks held government securities (which offered low rates of interest), and thereby helping to finance the burgeoning deficit. The CRR was also raised during the period in order to ensure that there was no expansion in the monetary base with the rise in the SLR.

Both these maneuvers had serious consequences for the short and long term profitability of the banking sector. With a large proportion of their assets being in low yield government securities, in zero yield cash reserves, and in risky agricultural deposits, banks were squeezed and began to display a significantly weaker portfolio(and Vaidya,1997). This being said, their subsidized financing of the deficit through the 1980s in particular allowed for an impressive increase in the trend growth rate and in the rate of poverty reduction, especially in the 1980s. Public infrastructural spending was increased as was the credit provided to development financial institutions. The provision of agricultural credit and the increase in the mobilization of resources in the rural sector most likely were also key important contributors to this turn of events.

In 1991, a period of major macroeconomic instability, precipitated by a balance of payments crisis, led to the adoption of wide ranging economic reforms in India. A key element of these economic reforms was the restructuring of the financial sector towards a more market oriented approach, centrally, the refocusing of attention in banking to profit-making.

While the moribund performance of the banking sector had come under scrutiny in the 1980s, there was not much reform that was actually passed. It was the only with the favorable

[3] From a neoclassical perspective quantitative controls such priority sector lending requirements represent an inefficiency in adopting quantity rather than price restrictions (see, for example, Varma ,2003.)

conditions for change following the macroeconomic crisis of 1990, that the recommendations of the Narsimham commission in 1991 were seriously entertained. This commission brought out, in November 1991, a set of policy measures which were designed to overhaul the banking system, and which included the following main points.

The commission's recommendations were essentially to move towards a more liberal regime. First, and most crucially, the committee suggested, the pre-emption of bank resources by the government needed to be reduced sharply. To this end, a progressive reduction in the SLR and the CRR over a five year period was recommended. In addition, the interest rate on government securities, previously maintained at a low level needed to be revised upwards to be brought in line with market rates. In order to borrow from the financial markets, the government was to introduce and develop the Treasury bill market. Priority sector lending needed to be curtailed, and brought down by a factor of four, from 40% of total commercial bank credit to 10%. Concessionary finance, in the form of development finance institutional credit was to be phased out.

Second, the committee proposed the reintroduction of substantive competition (Sen and Vaidya, 1997). The simplest and most direct way to do this, it suggested, was to license new private sector banks, both domestic and foreign, and to relax branch licensing restrictions on existing and new banks. However, in order for the new system to be stable, the capital base of existing and weak banks was to be strengthened by recapitalization and public equity issues. In addition, the committee and later policy makers proposed prudential norms such as capital adequacy ratios to be followed, provisioning of bad debts, and clearer classification of assets.

Third, the interest rate structure of the economy was to be 'rationalized'. That is, the interest rate for lending rates was to be gradually liberalized from their various slabs and the regulations on the interest rate for other financial institutions was to be lifted

It is a measure of both the willingness and the capacity of reformers to push through changes in the first years after 1991 that virtually all of these proposals, bar the removal of the politically sensitive priority sector issue, were enacted into law. Table (1) provides a breakup of the regulatory changes that had taken place within the banking sector by 2002.

2.1 Distributional Consequences of Banking Sector Reforms

By most accounts, one of the most encouraging results of reforms was the restoration of the profitability of the banking sector. While there is some debate as to which sub section of the banking sector- public or private sector banks- has been most profitable (see for example D'Souza 2002), it remains that the threat of non-performing assets which absorbed policy makers in the early 1990s has receded[4]. This being said, there is evidence to suggest that much of this has come at the expense of those most protected in the period of social banking: the rural and urban poor. It is to this claim that I now turn.

One of the many reasons given for the reforms was in order to counter perceived urban

[4]In the early 1990s, gross non-performing assets represented about a quarter of total advances. By 2002, the ratio had come down to about a tenth (source: Reserve Bank of India website- www.rbi.org.in)

bias arising from distorted trade prices. Critics of liberalization have suggested that urban bias of a different sort, a direct neglect[5] of agriculture and the rural sector in general has come to occur.

A vocal critic of this process summarizes this as follows:

> What is perhaps more disturbing is that this deterioration in the status of the rural credit system is not by default but by design. The near total neglect of rural credit by policy-makers during the period 1991-96 is largely attributable to the adverse environment created by the financial sector reforms - reforms which were patterned on the Washington or Basle models, both of which obviously had little to offer in the area of rural credit. Reforms thus crowded out rural credit from the agenda of modernization of the financial sector.
>
> Majumdar,1999b

Certain indicators suggest that this indeed has been the case, with a growing disintermediation of formal finance for these sectors. Table (2) shows the change in the growth rate in bank branches by population group between 1980 and 1990. In a developing country with a vast hinterland, the distance to the nearest banking center can be a deterrent for obtaining formal loans. As can be clearly seen, the growth of bank branches has fallen in the rural and semi urban sectors from 1991 after seeing an increase from 1980 to 1991. In the rural sector, the absolute number of branches, in fact has declined. To the extent that geographical access to banks is an issue, this would suggest a first order disintermediation for the rural population.

More importantly, there has been a consistent reduction in the credit deposit ratios of commercial banks in these sectors. Figure 3.1 traces these trends. In the period of repression, there was a 60% credit-deposit ratio that was prescribed for the non-urban sector. In the late 1980s this target was being achieved quite consistently in the rural sector. Post reforms, however, there has been a steady decline in these ratios. In 2000 the ratio was 34% and 40% for semi urban and rural areas respectively. There may be both supply and demand factors that are responsible for this decline. First, from the demand side, there has been a significant reduction in public investment in agriculture and the rural sector(Rao, 1998). If private sector investment is complementary in the sector, one might expect a fall in the demand for loans. However, as Majumdar 1999b has shown, despite the decline in aggregate demand, there is a significant excess private demand for credit in these sectors[6]. The supply explanation proposed, viz. that banks attitude towards restoring profitability has led to the drying up of funds appears to be better supported. In addition,the availability of high return, low risk returns in the form of government securities has obviated the need to find good projects on the part of commercial banks.Following liberalization then, the 'supply

[5] A senior public official wrote to the Economic and Political Weekly in 1999 that " That rural credit has become unfashionable is evident from the fact that the subject is accorded only residual focus in the various congregations of our bankers. The placement policy in vogue in our banks is such that exposures in rural credit or agro-financing rarely count for promotions" (Muralidhar, 1999.)

[6] He estimates that in 1998, such excess liquidity was about Rs. 65,000 crores, or about 15 billion dollars.

leading' role that banks displayed in the 1980s (which certainly did contribute to improved agricultural growth poverty reduction trend rates) has been clearly abandoned.

Scheduled commercial banks have become increasingly the major source of funds for agriculture and allied activities. As Figure2 below shows, they constitute about 45% of credit received by the sector in 2001 from about 1% in 1971. The other major sources of credit are the primary agricultural cooperatives. As the agricultural sector has become more dependent on commercial banks,it is also more vulnerable to interest rate fluctuations in the rest of the economy and the profit making imperatives of the banking sector.

In addition, Regional Rural Banks (RRBs), Development Financial Institutions (DFI's) and the National Bank of Agriculture and Rural Development (NABARD) also direct substantial formal credit towards these sectors. Unfortunately for agricultural borrowers, there have been serious problems with these conduits of finance as well. Under the reforms wrought by liberalization, regional rural banks have had to forego access to concessionary finances. This, combined with the fact of increased distress in the rural sectors, issuing from liberalization in agricultural markets and a lack of public investment has meant that the health of these banks has become increasingly compromised.

One attempt to revive rural credit was the creation of the Rural Infrastructural Development Fund (RIDF) with a corpus of Rs 2,000 crore at NABARD in April 1995. This initial capitalization was increased by the United Front Government in 1996-1998 to the Rs. 8000 Crore. However, as Majumdar(1999a) points out, although the funds were earmarked, there has been very little real utilization in terms of credit disbursed. Although the reasons for this lack of utilization are not completely understood, Majumdar suggests that poor governance and a lack of interest in agrarian development on the part of the state have been crucial.

Figure3 below shows the marked decline in the relative amount of funds flowing to agriculture and the small scale industrial sector. It must be remembered that these sectors still comprise the sectors with large potential for employment generation, although the informal services and manufacturing sectors have been absorbing increasing amounts of surplus labor. Though agriculture and small scale industries have fallen as percentage of GDP, there is little to suggest that their demand for credit should fall so rapidly, given, for example, the need for modernizing irrigation and other specialized inputs. Banerjee et al.,2004) show that private banks lend about 5 percentage points less to agriculture than do nationalized banks. With the expansion of private banks therefore, credit has been expanding more quickly in the non-agricultural sector.

Another area where there has been a change in financing patterns at the lower end- both in rural and urban areas- has been in small borrowal accounts (SBA's). Table (3) below lists the number of small borrowal accounts (or accounts which have a credit limit of less than Rs. 25,000) in the scheduled commercial banking sector from 1984 to date. As can be seen clearly, through the 1980s the percent of all accounts which were SBA's and the share of SBA's in all credit advanced by the banking sector remained steady, but declined dramatically in the 1990s. From 20% in 1984, SBA's accounted for only 5% of credit advanced in 2001. It could be argued that with growth and inflation, there is a natural tendency for the share of SBAs (as defined) in the system to decrease. However, to make the case that this is the reason

for the decline, one would have to argue that growth in the 1990s was significantly higher than in the 1980s, more weighted towards the lower ends/sectors of the income distribution, and/or that inflation was significantly higher in the 1990s. None of the above explanations square with the facts. As such, it seems evident that banks are turning to expand their portfolios with larger, more profitable accounts while discriminating against lower income borrowers.

Another axis by which to look at the distributional impacts of reforms is by assessing the credit availability by state. The table 3.4 displays the trends across India on average and in the poorest states (the BIMARU states and Orissa) on average. Credit deposit ratios have been falling steadily across the country and especially so after the reduction of directed lending requirements in the early part of the 1990s. However, the credit deposit ratio in the poorest states (accounting for more than a quarter of India's population) has fallen precipitously, especially in the late nineties. While these states have always seen a lower credit deposit ratio than the Indian average, presumably because of fewer profitable lending opportunities, there appears to have been a disproportionate decrease in credit towards those areas, with the difference in credit deposit ratios between those states and the all India average tripling over the last five years of the nineties (from 5 to 15 percentage points). Once again the pattern is clear, with the availability of formal credit to the poorer states drying up. As Shetty, 2004 argues, the pattern is repeated at the district level as well.

2.2 Priority Sector Lending

While there has been substantial easing of banking restrictions, the 40% requirement remains in place for priority sector lending, despite the recommendations of the Narsimham committee[7]. In addition, foreign banks are required to target about 10% of their funds towards export oriented firms. That such a substantial portion of bank funds remains targeted credit might suggest that banks are still meeting the social goals suggested by previous administrations. In fact, the major way in which priority sector lending has continued untouched has been because of the expansion in the definition of the priority sector . Moreover, this definition of what constitutes priority sector lending is not restricted anymore to those sectors which were traditionally seen as weaker[8]

Dasgupta, 2002 has collated some of these changes. In particular, the following bear mentioning. First, there has been an increase in the ceiling for short term credit advances (sometimes called crop loans) from Rs. 5,000 to Rs. 100,000 in the post reform period. While the move may appear to be increasing credit to farmers, in fact it has shifted credit from small, marginal farmers to richer farmers, since the agricultural credit target can now be reached by lending to fewer, less risky borrowers. In addition, credit for plantation crop which was extended only to small farmers originally has now been extended to all farmers. Finally, despite a change in cropping patterns towards greater non-food crops among all

[7]See Srinivasan,1995 for a study of the evolution of priority sector lending.

[8]By contrast, the pre reform rationale for priority sector lending was precisely in order to provide credit to the poorer sections of society. As the Krishnaswamy committee suggested "the maximum benefit should be invariably available to the weaker sections."(Reserve Bank of India ,1981)

farmers,(cf planning commission report,2000), small marginal farmers are more likely to have a larger proportion of food crops for subsistence purposes. As such, the reforms which extend credit to both food and non-food crops benefit the larger farms disproporionately. Another change post 1991 is the inclusion of the purchase of motor vehicles as a part of direct advances to agriculture. While the move ostensibly allows for farmers to have more control over transportation of agricultural produce, in practice, it is only useable, once again by large farmers who can diversify to non agricultural activities.

At least partly as a result of these changes financing patterns within the agricultural sector shows significant decreases in the credit advanced to small and marginal farmers post reform. Figure 3.4 below shows the difference between the share of credit advanced to farmers with land holdings of greater than 5 acres and the share of credit advanced to farmers with land holdings of less than 2.5 acres. In the decade of the 80s this difference trended downwards, from above 30% in 1981 to about 15% in 1990,suggesting that there was a great access to loans for small and marginal farmers in this era. In the post reform period, however, there has been a substantial increase in this difference, suggesting, by contrast diminishing relative access to finance for the poorest. While it is certainly possible that there have been some demand side effects (i.e. small farmers have less demand for credit), this militates against the growing evidence of agrarian distress induced by lack of credit opportunities (cf. Vakulabharanam, 2004).

It is true that a real side collapse in the agrarian economy in the 1990s has meant that risk adjusted returns from lending to the rural sector were less than the relatively high interest rates offered on public debt. Yet, to ignore the supply side is equally problematic. There is a growing consensus that in developing countries as a whole, and certainly in India, agriculture and allied activities have seen distinct underlending given expected returns (Banerjee et al, 2004, Cole 2004). In the case of India, evidence from the pre reform period shows that the non-liberal policy of forced lending contributed to a virtuous cycle of growth. The opposing vicious cycle of low lending, low growth, low returns and further reduced lending has been a central story of the 1990s. Shetty,2004 succinctly summarizes the supply leading role of finance in agriculture.

> The annual growth of non-farm rural employment in the 1980s (1977-88) was 4.3 per cent but it has fallen to 2 per cent per annum in the 1990s (1988-2000). The level of farm employment has stagnated in absolute terms during 1993-94 to 1999-2000 against a growth of 2.23 per cent during 1983 to 1993-94. Growth of agricultural production has suffered a serious deceleration in the 1990s [2.4 per cent per annum] as compared with the 1980s (4.5 percent). Though there were many other forces operating in the economy to give a boost to farm and non-farm output and employment growth in the 1980s, liberal availability of institutional credit undoubtedly aided the process; the converse is equally true that in the 1990s the stunted growth of farm (or rural) employment and output has been due to, amongst other factors; limited availability of bank credit.
> Shetty, 2004

A second point made by Dasgupta is the inclusion of sectors which have reasonably easy

access to formal finance without additional concessionary finance. A prime example is the October 1998 directive under which loans to software industry with a credit limit upto Rs 1 crore from the banking system were treated as priority sector lending. While loans to small scale industries (industries with a turnover of less than 1 crore) were earlier justified as providing an avenue for blue collar workers, it is entirely unclear how providing easy credit to a knowledge based industry is supposed to do the same.

Finally, another major change in the priority sector lending list has been the inclusion of housing for middle income families. Housing loans through the priority sector requirements was earlier reserved exclusively for very poor families. The raising of the ceiling to Rs. 5 Lakh in 1999 means that loans have moved towards middle income households who are better credit risks, while reducing the need for extending housing loans to poorer families in order to meet the lending requirement.

Taken in sum, therefore, while the priority sector lending requirement is unchanged in the level of credit advanced, there have been profound changes in the composition of priority sector lending. ShahJahan, 1999 argues that the expansion of the coverage of priority sector lending and the increasing of the lending ceiling for crucial areas has meant that more credit is directed towards relatively more affluent sectors, leading to fewer non performing assets but very much at the expense of the most needy.

Overall, the story of finance in the age of reforms suggest a profound gap between what is fiscally prudent and profitable for banks and financial institutions in a liberal, competitive requirement and the social needs of a society in India. Banks have become increasingly constrained or apathetic in directing credit towards areas which have traditionally been weaker. Publicly backed financial institutions have not been able to bridge the excess demand for credit, in large part due to the withdrawal of the state from the process of intermediation. and the inability of favored alternative sources of finance principally microcredit, to bridge this gap[9].

An untold number of smaller borrowers have thus been forced, in a deeply fragmented financial sector towards high cost informal financing. Some of the social consequences of this financial disintermediation, in the form of increased peasant distress (cf Vakulabharanam 2004), lower employment generation (cf Sundaram, 2004), informalization (Pais, 2002), lower rates of poverty reduction (Pande and Burgess,2004) and lower growth (Dutt and Rao 2001) is quickly becoming more evident. Ramachandran and Swaminathan, 2005 have collated

[9]Ramachandran and Swaminathan ,2005 contest the preassumed efficiency of microcredit. They write:

> The international evidence on administrative costs of NGOs shows that these costs were high (and administrative costs are, of course, the major component of total transactions costs) and relatively higher than those of commercial banks.NGOs cannot match the economies of scale of a comprehensive system of banking (in the case of India, perhaps the best network of rural banks in the less developed world). Secondly, the costs of administration of NGOs controlled micro-credit have actually risen when NGO activity is scaled up.20 Thirdly, repayment rates in NGO-controlled micro-credit projects are related directly to the level of administrative costs and mobilization efforts... For the state to withdraw from the field and hand over small-scale credit to NGO-controlled micro-credit organizations is, in effect, to undermine and weaken a major national asset, the widespread rural banking system.(p14-16).

detailed case studies from on the social impacts of financial liberalization in several rural areas in the decade of the nineties and early 2000s. Their conclusion is unequivocal.

> If financial liberalization had the effect of damaging the system of formal credit severely, our case studies show that changes in national banking policy have had a rapid, drastic and potentially disastrous effect on the debt portfolios of the income-poor. In general, as formal sector credit withdrew, the informal sector rushed in to occupy the space that it had vacated. Although it is clear that chronic indebtedness among the rural poor is a problem that cannot be solved by banking policy alone, and that the abolition of usury requires agrarian reform, a decisive change in banking policy is essential for the very survival of the working people in rural India. Ramachandran and Swaminathan,2005(page 23)

3 Government Finance

How is the relationship between financial liberalization, interest rates and government expenditure relevant to questions of distribution? In developing countries, the state often remains the only agent that can represent, however imperfectly, the interests of the poor, and transfer resources to these groups. Apart from its considerable role in redistribution, there is the fact that at least in the formal sector, the state provides an enormous source of employment. As such, the process of financial liberalization given these links addressed above might involve a subtle but powerful change in national priorities. At one level the government must prioritize to maintain investor confidence, both domestic and foreign, in its fiscal solvency by refraining from repression and letting interest rates remain high. At the same time it cannot easily maintain its commitment to other (particularly poorer and diffuse) constituencies. This is especially so because of the fact that interest payments cannot be delayed, while development expenditures can. With a rise in the interest burden there is a 'fiscal squeeze' (Rao, 1995), particularly if reforms on the real side are reducing government's tax revenues. As a result, there is a new pressure which varies from country to country, depending on such factors as the relative openness of the capital account, the exchange rate regime and the for governments to reduce government support for social sector spending and subsidies, expenditures that are crucial both to the poor and to the long term infrastructure of the economy.

If, indeed, financial openness changes the debt structure of the state and reduces its direct sources of revenue, the stream of public spending may be subject to sudden reversals, depending on perceived fiscal solvency. Moreover, much of public expenditure, especially welfare and social sector spending requires large and consistent outlays.

In the first few years following financial liberalization, as table (3.5) shows, interest rates rose steeply across all types of securities and money markets as could be expected following a period of financial repression. The resultant sharp squeeze in monetary and credit growth resulted in sluggish industrial investment and growth, and in the overall economy in general. Between 1994 and 1999 the economy grew at an annual rate of 4.5%

During this period, as can be seen in table 3.4, the fiscal deficit remained relatively stable at between 5% and 7 % over the whole period. While this level was far below the pre reform peak of 8%, the high fiscal deficit continued to be blamed by the votaries of liberalization as the fundamental reason for the high real interest rate (Khatkhate and Villneuva, 2001). An inability to control spending and a predilection towards profligacy and vote banking was seen therefore as a central cause for industrial sloth and macroeconomic sluggishness. Critics of the reform process pointed to a reverse causality, namely that high ex ante real interest rates, itself caused by liberalization, restrictive monetary policy and increased international exposure, had led to an increased interest burden on the Fisc, which in turn prevented the deficit from falling[10].

For the most part, the experiences of the later years of the post reform period has proved the critics right[11]. With, if anything, a small increase in the fiscal deficit, interest rates fell in the first half of the 2000s, due to a combination of RBI policy, international capital surges and relatively slack demand for credit. In 1999-2000, with the high real interest rate regime still continuing, enormous pressure was put on the RBI from industry to reduce rates. The bank responded by cutting bank advance rates aggressively and lowering the cash reserve ratio. Despite a deceleration of growth in bank deposits (due to a growth of competition from mutual funds), the years between 1999 and 2003 saw a large increase in liquidity from various factors. International capital inflows increased substantially all around the world with recessions occurring in the core global economy. Asia was certainly the largest recipient of these flows, and India was no exception. Reserves in India grew enormously-perhaps even inordinately[12]- with foreign exchange reserves as a fraction of M0 rising to over 10%[13]. In addition, there was a reduction in the cash reserve ratio by two percentage points, and a further increase in liquidity from the proceeds from the Resurgent India Bond issue in 1999.

These heavy and multi pronged interventionist measures from the RBI, in a period of sluggish growth and historically low inflation rates, led to a large overhang of liquidity in the system, which was slowly absorbed into the economy as it picked up in the next two or three years. While there was a definite increase in demand for credit, this was far below the rate of growth of supply. As Patil,2003 puts it:

> The main reason why interest rates continually moved southward during the early 2000s was that there was a slackness in demand for funds from almost all the sectors of the economy except the government. The flood of liquidity

[10] A charged debate on this issue was had, inter alia, in the Economic and Political Weekly between Prabhat Patnaik, on the one hand and Khatkhate and Villneuva on the other.

[11] Chakraborty ,2002 shows that with a VAR methodology, there is a unidirectional relationship between interest rates and the fiscal deficit, with the relationship running from high real interest rates to a high fiscal deficit in India in the 1990s.

[12] The Economic and Political Weekly writes in 2003, "Given its current level of dynamism, it is difficult to explain the Indian economy earning/ acquiring over 25 billion dollars of foreign currency assets in a single year"(EPW, 2003a).

[13] The rather elaborate capital control measures enforced by the Indian authorities (which allows inflows rather freely but has stringent rules for outflows) no doubt kept these finances in, even in a period of relatively slow growth.

expansion has been such that even large government borrowings have not been able to arrest the continual decline in interest rates.

As a result of the combination of these factors, interest rates fell to a 30 year low by 2003.

While the low interest rate era seen of 2003-2005 has certainly reduced the interest burden on the government, it remains at a high level, mostly due to accumulated debt. Rangarajan and Srivatsava, 2005 note that the 1990s saw a relative increase in debt absorption compared to the 1980s because of the fact that the difference in growth rates and interest rates fell in the 1990s[14]. Figure5 depicts the public debt burden increasing sharply in the 1990s and running at between 2 and 3 percent over the last five years of the 1990s, before reducing in 2000. While these levels do not an enormous burden in terms of worldwide standards, it remains a great deal higher than the levels of less than one percent maintained throughout the 1970s. A factor in India's favor is that her insistence on acquiring long term rather than short term debt has also meant that the latter is a small part of total outstanding debt (5.3% in 2003).

Table (6) shows that the interest burden as a percentage of total expenditure for both the central government has continued to rise through the 1980s and 1990s. As a percentage of total expenditure, interest payments have increased from 12% to 30% from 1980 to 2001.Although in the years following, the fiscal strain from interest burdens fell, the interest burden remains at 28% of all expenditures.At the same time, from the revenues side, the squeeze is evident. There has been a fall in the overall tax effort, as trade and customs duties have fallen, and the movement towards replacing these lost revenues with income and payroll taxes has been unable to make up the shortfall. Rao, 1998 defines a fiscal index as the difference between trade taxes and interest expenditures, or (Excise+Customs Duties-Interest Payments)/ GDP. The fiscal index for India shows the severe constraints that the reform process has placed on government's resources. While the high expenditure era of the 1980s began the strain the government's resources, the period following liberalization in 1992 to the end of the decade saw a much sharper squeeze.

Table (7) and (3.8) reports the changes in expenditure patterns for both the state and central governments over the period. As can be seen, interest payments have occupied an increasing share of total expenditures, especially over the middle and latter half of the 1990s, the period of financial liberalization. By contrast, capital expenditure and expenditures on development fell as a percentage of expenditures, both because of the changed priorities under structural adjustment and because of the fiscal squeeze.

To assess the coeval effects of increased interest burdens and decreased tax collections on public expenditure the following equations may be estimated for states and the centre for the period 1972-2002. I follow the model used by Khattry ,2002 who uses the model to assess the impacts of trade liberalization. The two interaction terms are introduced in order

[14]In the 1980s, 72% of the increase in debt could be written off by increase in the growth rate. In the 1980s, only 62% could be written off similarly.

to conduct a minimal but sufficient structural break evaluation[15].

$$DE_t = a + T_t + I_t + T_t * L + I_t * L + L \tag{1}$$

$$KE_t = a + T_t + I_t + T_t * L + I_t * L + L \tag{2}$$

Where DE= Social Expenditures/GDP, KE= Capital Outlays/GDP, T is Tax Revenue/GDP, I= Interest Payments by GDP and L is a Liberalization Dummy (1 for the period 1992-2004, 0 otherwise). Social Expenditure in the case of the center is Development Expenditure+ Transfers to the States, while Social Expenditure for the states is simply development expenditure.

The results of the regressions, listed in tables (3.9) and (3.10) provide some additional evidence for the negative effects of the interest burden on expenditure for both states and the center, but especially for the former. A rise in the state interest payments to GDP ratio of 1% has a more than proportional negative impact on both development and capital expenditure. For the center, while interest payments do not have a statistically significant effect on expenditures, the period of liberalization appears to have been one in which interest expenditures did significantly squeeze development expenditures. The concurrent reduction in tax revenues from tax reforms meant that the fiscal squeeze was still felt.

To be sure, some of the reduction in expenditure has occurred because of changed priorities (defence spending, for example has seen no cuts). This analysis, however, suggests that liberalization did work so as to constrain such expenditures[16]. An initial hope was that development expenditure, especially in the form of infrastructural spending would be taken up by inflows of foreign capital. However, this has not come to pass.

These regressions are relatively simple and are meant to provide substantive correlations between government expenditures and fiscal pressures.[17]All in all, the data is consistent with the notion that financial liberalization has increased interest rates and contributed to a fiscal squeeze in India (especially for the budgets of the states). While there is a matter of prioritization of expenditure, for the most part, governments may have chosen (or have been forced) to reduce development and capital expenditure. To the extent that it is the poor who benefit disproportionately from development and capital expenditure, this has a clear negative effect on distribution.

4 A Brief Consideration of the McKinnon-Shaw Hypothesis in India

The McKinnon and Shaw hypothesis (McKinnon, 1973, Shaw, 1973) provided the fundamental theoretical impetus for policy makers in their support of liberalization. Indeed, the

[15]The Johansen-Juselius test indicated that the series in the equations are cointegrated, and that thus,further differencing of the series is unnecessary and the OLS regression can be carried out.

[16]As table 6 also shows, in the low interest rate era from 2000-2003, there has been a definite increase in development expenditure as a percentage of total expenditure.

[17]A more complete analysis might consider demographic effects, institutions and pay greater attention to causation and time-series effects.

allocational benefits of a liberal financial regime were considered the major reason for the shift and as such, while the distributional consequences of financial liberalization are considerable (as has been argued from the previous sections), they were perhaps seen as of secondary importance. In order to evaluate the policy shift fairly then, some (brief) attention needs to be paid to its success in terms of the predicted effects on savings, intermediation and growth.

The McKinnon and Shaw thesis at its core suggests that the government uses financial repression as a source of captive funds and that the redressal of these distortions should result in more capital being freed for the private economy. Freeing the economy from sub-market interest rates would result in more savings, more efficient allocation of resources and hence more investment and output growth. By contrast, Taylor,1983 and more sophisticated later accounts (Rao, 1995) suggest that the final outcomes of financial liberalization on macroeconomic outcomes depends heavily on the linkages between the informal and formal credit markets. According to Taylor, the reserve requirements of the formal sector may reduce the total supply of funds to the whole economy as credit flows from the informal to the formal sectors. Just as importantly, the higher real interest rates would result in greater firm distress and a contraction in investment and aggregate demand.

The macroeconomic evidence on the merits of the McKinnon and Shaw arguments is at best mixed. The interest rate pattern appears to have followed the predicted patterns of an initial interest rate increase (from 1991 to 1996), followed by a steady decline thereafter. However, the reason for this decline was not as per the McKinnon-Shaw hypothesis(liquidity expansion through increased household savings and flows from the informal to the formal credit markets, followed by competitive decreases in the lending rates). Instead, much of this interest rate decline was due to active central bank intervention in releasing liquidity into the system (especially of foreign inflows). Despite the decline in inflation rates in the middle to late 1990s, lending rates of banks remained high and there were no competitive pressures to push these down. Active monetary management by the RBI was therefore crucial in reducing rates. As predicted by the McKinnon and Shaw thesis, it certainly true that the financial system has become deeper through the 1990s. from 1990 to 2000, the ratio of M2 to GDP rose from 40% to 52%- a rise of 30 percentage points, which compares favorably with the rise of 20% in the preceding decade[18].

This increased liquidity and higher levels of saving did not however translate into great levels of private investment. The private investment to gross domestic product ratio declined from 12% to 11% from 1990 to 1994 and has risen to and remained at about 12% since[19]. There are two major reasons for this. First, banks have taken to procuring government securities which provided a safe and high return. This is at some level unsurprising since the state remained the major engine of aggregate demand through the nineties. The government spending to GDP ratio rose from 27% in 1990 to 37% in 2002[20]. Market borrowings from the government have consequently been very high. Given the high demand from the government bond market and the safe returns,in 2003 banks were holding close to a full 15% more in

[18]Source: World Development Indicators.
[19]Source: Penn World Tables, 6.1Heston et al. (2002).
[20]Source: Penn World Tables, 6.1Heston et al. (2002).

government securities than they needed keep from statuatory requirements(40% rather than the requisite 25%)(EPW, 2003aEPW (2003a)). Equally importantly, industrial recession, partly brought on by high interest rates in the mid 1990s meant that there was a reduction in the demand for private investment borrowings.

The McKinnon-Shaw thesis also suggests that liberalization would improve access to formal credit. That is, liberalization eliminates credit queues and so allows access to bank funds for any borrower who is willing to borrow at the going rate. It is here that the thesis comes up against its most serious shortcomings in the case of India. As the evidence from the earlier sections suggest,there is substantial excess liquidity in the rural credit system, and there has been an active disintermediation of a large proportion of the population. Similarly, as some have noted (EPW, 2003a), small and medium borrowers are facing substantial credit constraints. Finally, there is evidence that there has been a flight of low-end borrowers to the informal sector. Ramachandran and Swaminathan, 2001 argue on the basis of field studies that:

> The 1990s have not just been a period when the share of informal sector loans in the debt portfolios of the poor increased sharply; they have also been a period over which the process of informalization of the credit market intensified (pp.15).

The reasons for this gap between demand for formal loans and their supply are not completely clear. Some authors (Varma, 2003, Banerjee et al, 2004) suggest that this reduction of credit availability is possibly because of over regulation. They argue that stringent anti corruption legislation prevents bank officers from extending loans to potentially risky clients. Others argue that in an era with a large demand for credit from the government, banks are happy to engage in 'lazy banking'(EPW, 2003a), since the return on asset ratios for more risky low-end borrowers is low. Finally, others suggest that the role as agents of development that the banks played in the pre-liberalization period has been abandoned, and as such, competitive pressures outweigh the risk and cost of lending to poorer borrowers.

A combination of these factors is possibly at work. In any case, the fact that the formal credit market is not in equilibrium(in the sense that there are unsatisfied borrowers at the going interest rate) is indisputable. As such, this finding should be seen as contradicting the McKinnon and Shaw prediction. There is perhaps a case to reintroduce mechanisms through which to compel banks to lend to worthy borrowers who are credit constrained in a liberal regime.

5 The Capital Market

As with any movement towards a market based system of finance, the experience of the Indian financial system has been one of increasing complexity and distinct changes of the financial market. If the summary of section(I) suggests that there has been a distinct contraction of financial intermediation in the agrarian economy and small scale industry, there has been an equal and opposite explosion in the availability of credit in urban India. Financial liberalization has resulted in the rapid development of a market based system of finance

and a wide array of financial instruments. In addition, liberalization has resulted in the appreciation of asset prices, especially corporate securities and land held by the relatively affluent. It is to the consideration of these changes that I now turn.

5.1 Domestic Capital Market Reforms

A central concern noted in the Narsimham committee report was that the capital market was severely underdeveloped for an economy of India's size and complexity[21]. It proposed that the first steps towards developing such a resource for funds were to remove restrictions on the pricing and issues of capital in the Indian bourses and to set up a regulatory body in this regard. In 1993, the Securities Exchange Board of India (SEBI), an independent oversight body set up in 1988 had its powers decidedly increased by the passing of the SEBI act. In 1994, the National Stock Exchange, was established. The NSE was central to modernizing the capital market, introducing electronic trading and order matching. The reforms essentially broke the monopoly of Bombay Stock Exchange brokers in capital markets. In addition, there was an active encouragement of mutual funds through support to the alliance of mutual funds. Table 3.11, adapted from Bajpai,2003 below summarizes some important domestic reforms in financial markets. These changes were rapid and were more or less all completed by 1998.

5.2 International Capital Market Reforms

Given the alacrity with which the domestic financial system was deregulated, the well- known sluggishness of reforms in external capital markets may seem surprising. In contrast to other countries undergoing liberalization in the same period (notably some East Asian economies and former Soviet Republics), India adopted a far more cautious approach to international financial deregulation: and there has been a careful, gradual and as of yet incomplete deregulation of international capital flows.

Some commentators have explained this as occurring because of the unwillingness of politically entrenched groups to forego rents. While this may have been contributory, it is at least equally the case that the gradualism of Indian deregulation was an active goal of policy makers (see Ahluwalia, 2002, Acharya, 2002), and the result of the lessons they had learned during the crisis of 1991.

The decade of the 1980s was one in which India had turned to (previously ignored) external capital markets for finance, in particular to commercial borrowing from non-resident Indians. Over the period, India, which had been one of the more reliable debtors in the developing world, amassed a large volume of debt, accounting for 31 percent of capital inflows by 1991-92. The 1990 BOP crisis was partly precipitated and certainly exacerbated by a wholesale withdrawal of funds and capital flight from the special commercial deposits of Non Resident Indians. By March 1991, the crisis had reached severe proportions, and with

[21] As Echeverri-Gent ,2002 notes, these recommendations were very similar to an earlier set of recommendations of a World Bank team in 1985.

foreign reserves falling to a low of $ 1 billion, India had barely enough reserves to maintain two weeks worth of imports. The story that followed is a familiar one. India turned to the IMF for an emergency loan, and the resultant attached conditionalities led to the adoption of extensive liberalization measures and a movement towards a more free market economy.

The episode was not without its lessons for policy makers, however, and, indeed much of Indian Capital Account Management since then can be seen as dictated by the experience garnered in this period[22] . In the years following, Indian Authorities have been proactive in maintaining safeguards against financial instability, and reducing external vulnerability. As Nayyar,2000 says in regard to the Indian initiation to reforms:

> It prompted strict regulation of external commercial borrowing especially short-term debt. It led to a systematic effort to discourage volatile capital flows associated with repatriable non-resident deposits. Most important, perhaps, it was responsible for the change in emphasis and the shift in preference from debt creating capital flows to non-debt creating capital flows. (Nayyar 2000)

Crucially, the management of integration into the world financial market was based on fundamental asymmetries between residents and non-residents, and corporates and individuals. While non resident corporates enjoyed substantial repatriability of funds, this was severely limited in the case of individual non residents. Resident corporates must obtain approval of various sorts before exporting capital, and resident individuals are, for all practical purposes subject to very strict and low limited with respect to these

Given the experiences of the 1991 external crisis, there was a clear preference for some sorts of capital flows than others. For policy makers, there was a desire to be less dependent on debt inflows and more reliant on equity investment. Within the latter category, direct investment was considered superior to portfolio investment because of the volatility aspects.

To this end, the first element in the capital account to be decontrolled was Foreign Direct Investment in mid 1991.While the actual policy was not broad (international investors were allowed a 51% stake in a controlled set of sectors), symbolically it was a major event, since India had explicitly rejected FDI and multinational ownership of Indian assets in the late 1970s. These processes steadily moved forward, by 1993 when there were far reaching changes in the Foreign Exchange Regulation Act (FERA) of 1973. The policy granted equal status to both foreign and Indian-owned companies within Indian borders and began the process of liberalizing outward investments by Indian companies overseas. The process since then was somewhat more incremental, as more sectors were added to the open FDI list, and ownership ceilings were slowly but surely gradually lifted. Some of these reforms may have been used to guide FDI into certain industries, and it is certainly true that much of FDI was channeled into priority sectors such as computer hardware and software, engineering industries, services, electronics and electrical equipment, infrastructural projects, chemical and allied products, and food and dairy products.

[22]They have also been fortunate on two occasions when full capital account liberalization was pushed, to relearn from the misfortunes of other countries(the tequila crisis in 1994 and the Asian financial crisis in 1997), the potential difficulties of integrating with world capital markets.

The attitude towards portfolio investment has been equally gradual, although the development of a much larger market for currency and the development of a better-regulated stock market should also be seen as contributing to its increase. India's first attempt to capture part of the growing funds being channeled into emerging markets came during the second half of the 1980s, as India opened five closed-end mutuals for sale on offshore markets. These did not turn out to be central in attracting portfolio investment into India, and it was only after the initiation of the reform process that this process took off. In 1992, the first landmark legislation was introduced, with Foreign Institutional Investors being allowed to invest with full repatriability of proceeds, in a controlled manner, and with a controlled ceiling of shares being owned. In order to provide some legitimation of the process, the government set up an independent board, SEBI (Securities Exchange Board of India) that was charged with the regulation of foreign equity flows. The Bombay stock exchange (BSE), was, till the mid nineties, the premier stock exchange in India, and had a well deserved notoriety for lacking transparency and requiring relationships with powerful brokers to achieve quick settlements of orders (see Gent 2002 for more details). SEBI and the GOI attempted to redress this by creating the National Stock Exchange (NSE). Due to various factors, including breadth of coverage, modernized trading tools and the creation of a clearing system, NSE quickly became the largest stock exchange in the Indian financial market. In 1997, the American Securities Exchange Commission nominated the NSE as an eligible foreign custodian, which allowed foreign firms to invest with security. In the interim, the GOI also permitted (subject to their approval) the issuing of shares by domestic companies in foreign markets. These were the so-called American Deposit Receipts and the Global Deposit Receipts that contributed to the large inflows of foreign exchange into the country in the mid 1990s. By the late 90s, the limits on FII ownership of share capital had been lifted (although not to having majority stakes in most sectors).

Commercial borrowing in contrast to the other two elements of capital account liberalization has been quite remarkably curtailed. Again, this can best be seen as a result of the various lessons learned about debt in general and short term debt in particular. Commercial banks, unlike in some East Asian countries, have not been and are still not allowed to accept deposits or to extend loans which are denominated in foreign currencies. There is a small component of commercial borrowing, for limited amounts or specified maturities, which are based on a simplified procedure of automatic approval by the Reserve Bank of India. Most of commercial borrowing however required case-by-case approval from the government, and much of short-term debt was carefully regulated. The primary source of commercial debt in the 1980s, from Non Resident Indian deposits schemes, have been curtailed through the 1990s. The RBI no longer covers exchange rate risk and does not offer interest rate premia to NRIs.

Another element of financial regulation that has remained in the control of the. government has been exchange rate policy. As authors have suggested, much of India's intervention in external capital markets has been to maintain the stability of the exchange rate. Part of this is to do with the fact that Indian foreign currency markets are rather thin and therefore subject to volatility. While explicitly abandoning the dual exchange rate regime in

1992-1993, the RBI has had to manage the exchange rate through other means in order to prevent the large surges of inflows (and equally large outflows in 1997) from disrupting macroeconomic stability.

6 Distributional Consequences of Capital Market Liberalization

Capital market liberalization began in earnest in 1993 with the SEBI act. The BSE sensex index which stood at 900 points in July 1990 stood at 6600 points at the end of 2004[23]. The total market capitalization in the Bombay Stock Exchange (BSE) was less than Rs.100,000 crores in 1990. Fourteen years later, the aggregate market capitalization of the BSE and NSE (which came into existence in 1995) exceeds Rs. 1,200,000 crores, or an average increase of about 100 per cent a year during the 1990s (even after taking into account the 1994 and 1998 crashes). At the same time, the Indian economy few at about 6 % per annum.

Another measure of the explosion in finance accruing to the capital market is provided by looking at the ratio of market capitalization at the BSE to the assets of scheduled commercial banks. The ratio rose from 15% to 80% between 1985 and 2000 (see Table (12)

What are the proximate causes of this surge? Some of this change reflects the increase in the holdings of shares and debentures on the part of households. Table (13) below suggests that following liberalization there has been a decidedly greater interest in shares and debentures as a savings vehicle. The figures shown are certainly an underestimate of the amount of finance channeled towards the stock market given that mutual funds are sources of indirect investment into the stock exchange.

This being said, the stock market scam of 1992, in which Rs.54 billion of banking funds were diverted to artificially inflate stock prices had a very strong negative effect on investment in shares by households.Scams in the stock market and in the bond market have continued to deter households over the years (cf Shah and Thomas, 2002. In 1994, the M.S Shoes case resulted in a default of Rs. 170 billion, in 1995 the Sesa Goa and Rupangi cases resulted in losses of Rs. 60 million, in 1997 the CR Bhansali case involved losses of Rs. 70 billion. In 2001 another stock market scam, this time involving external speculators erupted. Ketan Parekh- a speculative broker, and several overseas corporate bodies conspired to rig share prices by investing from overseas accounts in Mauritius. Partly as a consequence of these scams, while the period 1990-1994 saw a large increase in ownership of shares and debentures in households (at the expense of deposits), 1995-2000 saw a sharp decrease in the share of financial assets held directly as shares and debentures owned by households.

Another cause for the surge in the stock market is external deregulation and the permitting of foreign institutional investment. The number of registered foreign institutional investors in the stock market rose from 18 in 1993 to 540 in 2004. These investors have brought in over Rs. 100,000 Crore into the Indian stock market since 1992, or over a fifth of

[23]Much of this appreciation has occurred in the early part of the dace, as the restrictions on international capital mobility have become even fewer.

private non financial companies market capitalization. . Kohli ,2003 finds a strong positive correlation between foreign portfolio investment and Indian stock price indices.

Finally, the opening up of the market to private mutual funds also meant a large increase in finance channeled into the stock market. Private mutual funds were able to obtain resources which exceeded resources mobilized by UTI and Bank Sponsored Funds. In 2004, private sector mutual funds obtained resources of over 42,000 crore or over 90% of all resources mobilized by mutual funds.

Given that the stock market has seen a vast increase in both in its valuation and its scope, it is useful to assess the distribution of stock ownership in India. What percentage of the Indian population has access to the stock market and benefits from its appreciation? Unfortunately, there are no time series available on the stock holder population of India over a long period of time. However, the few studies that have taken place provide some indication of the changes in stock ownership.

It is certainly the case that the investing population of India has grown between the 1980s and now (Sen and Vaidya, 1997). In addition, the distribution of share ownership in terms of geographical location of investors has become less concentrated in urban areas . This said, the stocks remain an asset that is owned primarily by the elite. The Society for Capital Market Research and Development carried out three surveys of household investors from 1990 to 1997, showing an increase in the total number of share owners from about 10 million to 20 million over the period (or about 1-2 percent of the population). In another survey done by the SEBI and NCAER,(SEBI-NCAER,2000, 2003) the proportion of all households in India who invest in the stock market was about 7.5%, with about 15% in urban areas and 4% in non urban areas investing in shares. The percentage of the population which invested in mutual funds was higher at about 10% of all households (see tables (3.14)-(3.17).

The SEBI-NCAER survey shows that the holding of shares, debentures and bonds, as might be expected, increases monotonically with the level of income of the household. As the table 3.17 below shows, households who earn more than Rs. 15,000 per month are about fifteen times more likely to hold UTI schemes or Mutual Funds and about seven times more likely to hold bonds, but only fifty percent more likely to hold fixed deposits than households that earn up to Rs. 2,500 per month. In addition, urban households invested more in non-fixed deposit assets compared to rural households.

In an interesting analysis, Rao,2004 measures the share of different categories of shareholders in total market capitalization at the BSE. The table below shows the share of the total market capitalization of non-government listed companies by five groups: Indian and foreign promoters, institutional investors, private corporate bodies and the general public from the study. The data suggest a strong concentration of ownership with promoters and with institutional investors (particularly foreign institutional investors). In addition, Rao finds that it is in precisely the most highly traded and larger companies that this concentration is highest, suggesting that promoters and foreign institutional investors have gathered the lion's share of the appreciation of equity. The pattern of sources of funds for non public, non financial companies suggest, also, that external funds as a percentage of total funds went from about 58% in 1985 to 72% in 1995 and down to about 35% in 2003 (RBI-Handbook

of Indian Statistics,2004)(see Table (18)).These facts provide some support for the idea that rather than acting as a vehicle for companies to access funds from the general public, the stock market appears to be increasingly geared towards attracting foreign portfolio investment and appreciating scrips owned primarily by the promoters.

7 Other Distributional Effects of Financial Deregulation

7.1 Wage Inequality and Foreign Direct Investment

A standard channel by which international financial openness may sharpen inequality is by increasing wage disparities between skilled and unskilled workers. If foreign direct investment flows into industries which possess a higher than average skill set, a higher relative demand for skilled labor will result in increasing wage inequality (Markusen and Venables,1997. Despite the neo-classical prediction that developing countries should see FDI inflow into low skill industries, much evidence across several countries suggest that relatively high skill industries see FDI inflows (Feenstra and Hanson,1995 for Mexico, Zhao, 2001 for China, Matsuoka ,2002 for Thailand)

Evidence of rising wage inequality in India has accumulated. Galbraith et al,2004 use data from the Annual Survey of Industries from 1983-1998 to suggest that pay inequality across industries and across regions has risen following the reform process. Dutt and Rao, 2001 write:

> There is anecdotal evidence on rapid rates of increase in the incomes of highly-skilled workers and managers in the 1990s, especially in transnational corporations. These increases are especially among those who are graduates of leading management and technology institutes, suggesting increases in the skilled-unskilled wage differential. However, we know of no aggregate data confirming this trend.

Banga, 2005 provides evidence for this trend. Using panel data on 78 industries at the three-digit level of industrial classification (National Industrial Classification) for the period 1991-92 to 1997-98, she finds that FDI, as measured by the share of foreign companies in total sales of the industries has a significant positive effect on the difference in the wages of skilled versus unskilled labor.

The result suggests that India has not been able to attract FDI into its low-skill export oriented sector. In the absence of an impetus to this sector, given a limited supply of skilled labor, the skill based wage disparities arising due to FDI may be expected to grow after 2005.

7.2 Consequences of Foreign Investment on Land Prices

One should not ignore one of the less studied distributional consequences of financial liberalization (especially international liberalization and the inflow of foreign capital): the effects on urban land prices. Nagaraj, 1997 and Nijman,2000 suggest that the latter has been among the most important forces behind the rise in commercial land values. Although legislation meant that foreign firms were not allowed to own property, the inflow of multinational firms as renters resulted an explosion in the real estate industry as developers expanded production rapidly in anticipation of high rental values. While there are no good data on the distribution of land in urban areas due to poor accounting practices, it cannot be doubted that the bulk of land and especially commercial property is owned by the relatively well off groups in society. The period from 1990 to 1996 saw an explosion in the value of land assets in the urban core. Following this, there was a tapering off of land prices till 2000 followed by a period of stabilization. Currently, in all the metros commercial land is about three and a half times its value pre 1990.

The Table (19) below suggests the impact of foreign capital as it entered Mumbai and Delhi during the initial years of liberalization and secondary metros like Bangalore in 2001-2005.

To summarize, therefore, financial liberalization and increased openness have led to a vast increase in the size, scope and valuation of the capital market in India over the period. Despite the perils of integration, prudential regulations have kept net capital inflows positive throughout the 1990s and India did not experience a financial crisis in a decade which saw at least four debilitating currency crises across developing economies in the rest of the world. The solid and relatively rapid development of a sophisticated market based financial system with a wide variety of asset vehicles and strong growth over the 1990s and 2000s certainly something that should be commended, but its benefits for the majority of India's population should not be overstated.

The limited evidence suggests that despite a growth in the investing population, it is a small proportion of households which hold stock market assets both directly and indirectly. Also, about half of the assets in the stock market are owned by promoters (and only about one fifth of the stock market is owned by the general public), suggesting that the majority of capital gains accrue to a very small group of the population. In addition, the stock market is increasingly dependent on and therefore vulnerable to foreign capital. Finally, given the relatively small section of the population that it directly benefits, the stock market has grown to have a disproportionate political importance. In May 2004, following the upset election in which the BJP party was defeated by a coalition of the Congress and leftist parties in the general elections, there was a sharp fall in the stock market and strong protests from brokers and institutional investors. The Congress in turn rushed to reassure investors that it had no plans to return to the state control of the past and even substituted the (apparently) left leaning Sonia Gandhi for the pro-reform Manmohan Singh as prime minister. The episode has much to say about the now firmly established importance of the stock market as an agent in Indian political economy.

8 Conclusion and Extensions

The empirical results from the previous sections strongly suggest that financial reforms have coincided with unequalizing processes in terms of access to and holding of resources in each of the circuits of finance considered. Causality is more difficult to establish convincingly. For example, it is certainly the case that changes in financial regulations have made it easier for banks to ignore lower end borrowers, but the reduction in credit flowing to such borrowers may also be simply a reflection of the lack of credit worthy projects.

The empirical trends from this chapter suggest that financial and particularly banking sector reforms have been linked with widespread financial disintermediation for the rural sector, for agriculture, for small scale industry, for small borrowers and in the poorer states. There is solid evidence of increasing movement to informal financing for these sectors. Indirectly, higher interest rates during the period have also hurt the poor disproportionately by precipitating a fiscal squeeze on the state's ability to make productive capital and development expenditure. Finally, domestic and international financial liberalization has led to the rapid development of the market based financial system which has unequivocally benefited the richer sections of society both in terms of increased efficiency as well as increased access to finance. While these trends are not in and of themselves evidence of growing inequality, it is very hard to reconcile these findings with either falling poverty or inequality.

What conclusions can be drawn then for policy makers? The story of Indian financial reforms provides a narrative about the difficulty of addressing social concerns in the presence of incessant demands for efficiency (narrowly defined as profitability of banking), and for the development and maintenance of a market based financial system. In addition it also gives an indication of the importance of fiscal squeeze and the constraints placed on the state under a liberalized regime. To the extent that policy makers are concerned about these issues, at least certain aspects of finance may need to retain regulation and regular oversight.

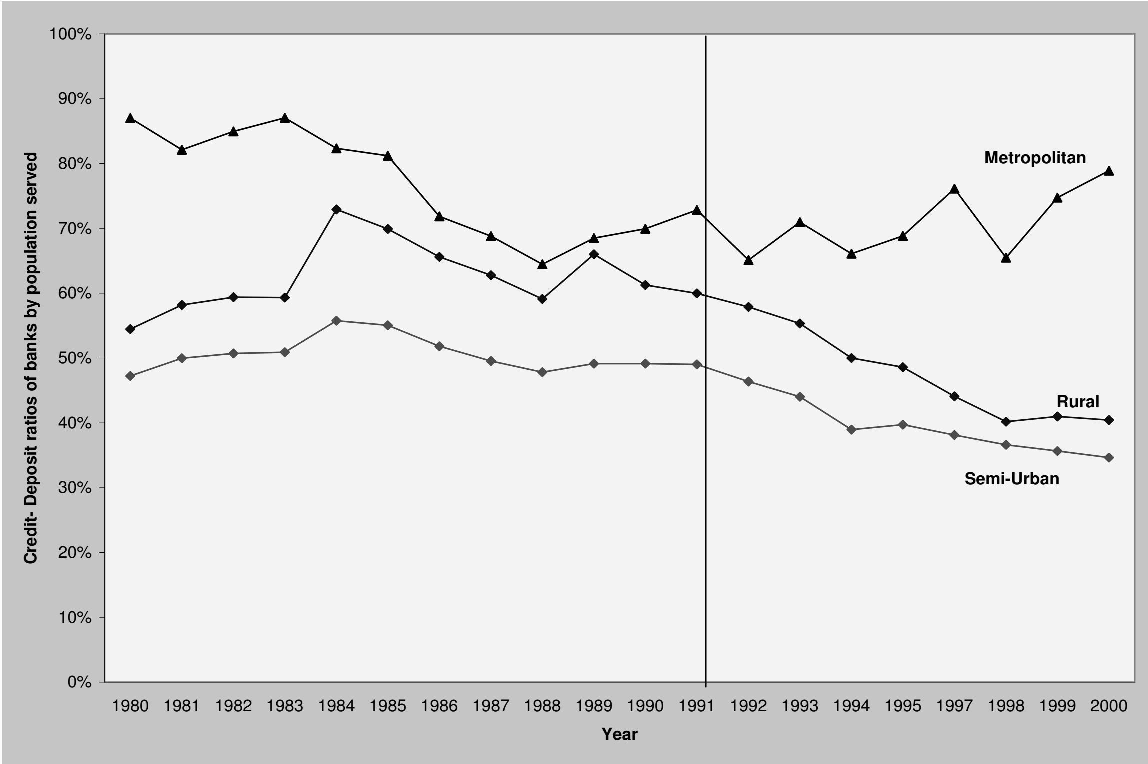

Figure 1: Credit Deposit Ratios by Rural and Urban Sectors

Source: Author's calculation based on RBI statistics

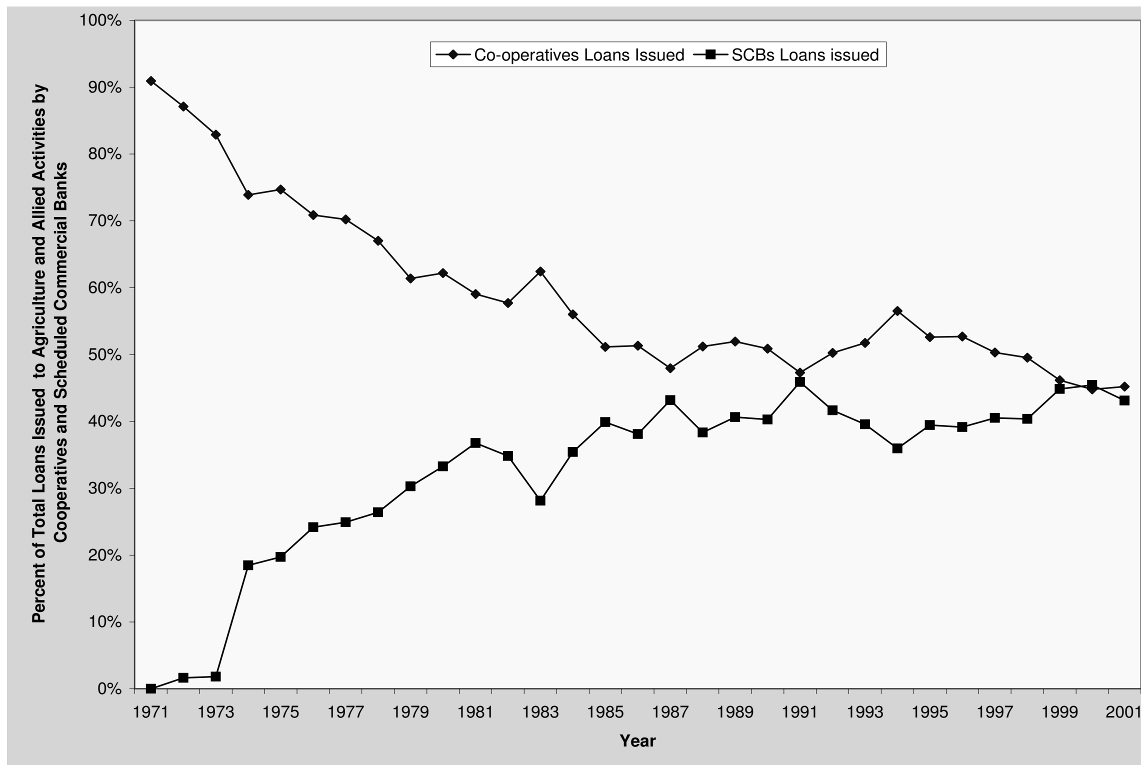

Figure 2: Credit to Agriculture and Allied Activities by Banking Intermediary.

Source: Author's Calculation based on RBI statistics

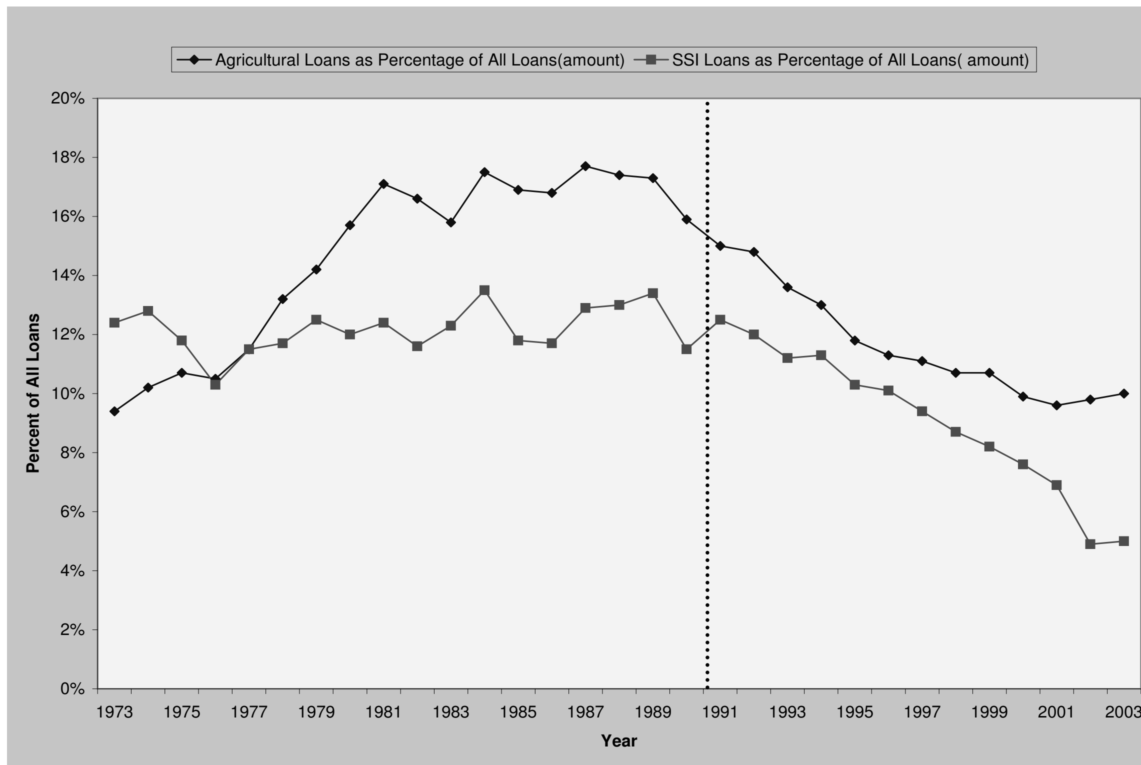

Figure 3: Declining Credit to Agriculture and Small Scale Industry Following Reforms

Source: Author's Calculation based on RBI statistics

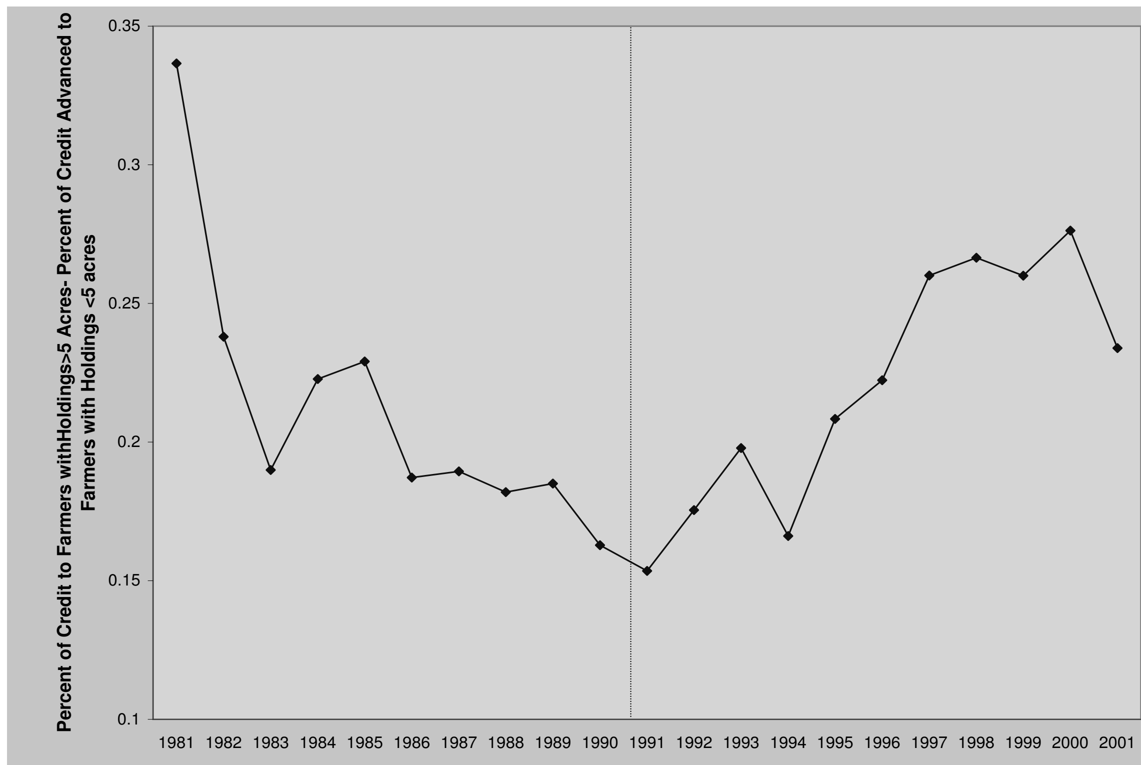

Figure 4: Credit to Small and Large Farmers Pre and Post Reforms.

Source: Author's Calculation based on RBI statistics

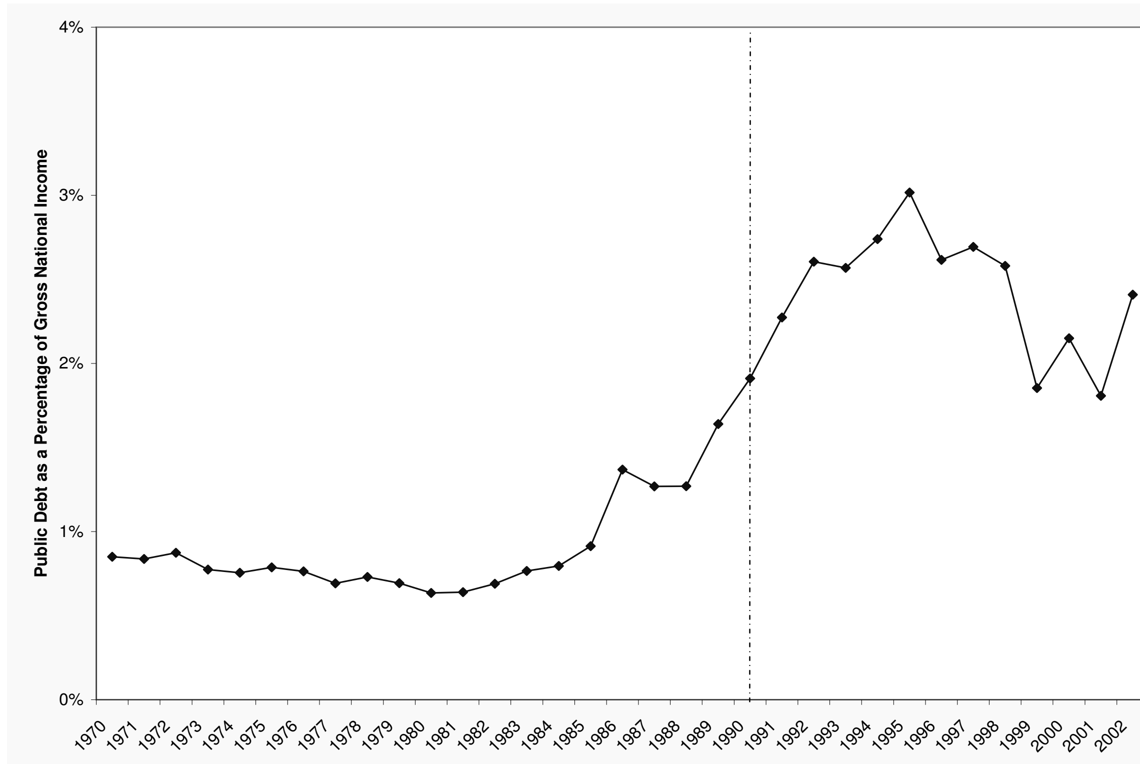

Figure 5: Public Debt in India

Source: World Development Indicators

Table 1: Recommendations of the Narsimham Committee and Enactment of Policy

Policy Proposal	Enactment
Reduction in Statutory Liquidity Ratio	The SLR was progressively reduced from 38.5% in 1992 to the suggested 25% in October 1997 where it remains to date.
Reduction in Cash Reserve Ratio	The CRR was progressively reduced from 15% in 1991 to 4% in 2002.
Reduction in Priority Sector Lending	While the 40% rate for priority sector lending remains unchanged, the definition of industries included in the priority sector, however seen a substantial increase in the sectors covered under such lending.
Introduction of Competition	Approval was given by the RBI for the establishment of new banks in the private sector in 1992.
Abolishment of Branch Licensing	Branch Licensing was considerably liberalized in 1993.
Interest Rate liberalization	Interest Rates match market rates more closely (although they were not completely liberalized).The lending rate was rationalized into three categories in 1993 from six before. The minimum lending rate on selective credit was abolished in 1996.

Table 2: Average Annual Growth Rate in Number of Bank Branches

Area	**1980s**	**1990s**
Rural	8.9%	-0.6%
Semi Urban	3.4%	2.5%
Urban	4.5%	2.3%
Metro	3.6%	4.1%

Source: Author's calculation from RBI statistics (www.rbi.org.in)

Table 3: Trends in Small Borrowal Accounts

Year	**Small Borrowal Accounts as percentage of all accounts**	**Share of SBA in all credit advanced**
1984	95.5%	20.5%
1985	95.6%	20.1%
1986	95.8%	22.5%
1987	95.8%	24.2%
1988	95.4%	25.4%
1989	95.0%	23.2%
1990	94.9%	22.0%
1991	94.9%	22.0%
1992	95.0%	21.9%
1993	94.2%	19.8%
1994	93.6%	18.3%
1995	92.8%	16.2%
1996	91.6%	14.2%
1998	87.5%	12.5%
1999	81.6%	10.0%
2000	72.2%	6.4%
2001	71.1%	7.0%
2002	66.3%	5.3%

Source: Author's calculation from RBI statistics (www.rbi.org.in)

Table 4: Trends in Credit-Deposit Ratio in BIMARU states and All India

	1985-1990	1990-1995	1996-2000
All India Average	61.3%	58.2%	55.8%
BIMARU* Average	58.3%	53.1%	40.1%
Difference	3.0%	5.1%	15.7%

*BIMARU= Bihar, Rajasthan, Uttar Pradesh, Madhya Pradesh, Orissa Source: Authors calculation based on RBI statistics

Table 5: Interest Rates in India

Year	SBI Advance Rate	GOI Short Term	GOI Medium Term	GOI Long Term
1980	16.5	4.70-5.74	5.70-6.30	6.20-6.98
1981	16.5	4.74-6.01	5.80-6.75	6.44-7.49
1982	16.5	5.32-6.43	5.81-7.02	6.45-8.00
1983	16.5	4.98-8.46	6.25-7.77	6.46-9.00
1984	16.5	4.50-7.08	6.67-9.04	6.47-10.00
1985	16.5	4.20-8.31	6.47-9.04	7.93-10.50
1986	16.5	5.42-9.84	6.49-9.50	8.38-11.50
1987	16.5	5.09-11.60	6.50-10.86	8.88-11.50
1988	16.5	6.86-15.78	6.51-11.73	9.17-11.50
1989	16.5	7.03-23.88	6.76-13.77	9.36-11.73
1990	16.5	7.56-18.36	7.69-15.06	10.05-11.80
1991	16.5	7.04-21.70	9.44-12.70	10.86-12.04
1992	16.5	8.37-26.26	9.50-13.42	9.91-12.38
1993	19	9.08-23.77	9.50-14.78	8.82-12.47
1994	19	11.86-12.86	12.70-13.30	12.85-13.43
1995	15	9.75-11.76	11.30-13.86	11.77-13.47
1996	16.5	6.00-14.28	5.75-14.07	11.84-13.02
1997	14.5	5.21-16.21	5.75-14.44	9.00-14.20
1998	14	5.50-17.69	5.20-14.00	9.00-13.17
1999	12-14	4.45-17.73	5.75-13.74	10.00-13.46
2000	12	3.18-14.30	6.50-13.84	9.79-13.11
2001	11.5	4.94-16.66	9.37-12.50	10.58-11.89
2002	11.5	5.32-10.96	5.14-13.85	7.41-10.86
2003	10.75			

Source: Reserve Bank of India

Table 6: Fiscal Deficit, Tax Revenues and Interest Payments

Year	Gross Fiscal Deficit as a percentage of GDP	Gross Tax as a percentage of GDP	Interest Payments (Center) as a percentage of GDP
1980	5.29	9.91	1.9
1981	5.77	9.15	1.8
1982	5.14	9.38	1.9
1983	5.64	9.38	2.09
1984	5.94	9.42	2.18
1985	7.09	9.54	2.43
1986	7.86	10.3	2.7
1987	8.47	10.54	2.97
1988	7.63	10.61	3.18
1989	7.34	10.54	3.39
1990	7.33	10.61	3.65
1991	7.85	10.11	3.78
1992	5.56	10.3	4.07
1993	5.37	9.96	4.15
1994	7.01	8.82	4.28
1995	5.7	99.11	4.35
1996	5.07	9.36	4.21
1997	4.88	9.41	4.35
1998	5.84	9.14	4.31
1999	16.51	8.26	4.47
2000	5.41	8.87	4.66
2001	5.65	8.96	4.72
2002	6.14	8.15	4.68
2003	5.9	9	4.69

Source: Reserve Bank of India

Table 7: Selected Components of Central Government Receipts and Expenditures

Year	Tax Revenue as% of Receipts	1.Of which: Direct Taxes*	2.Of which: Indirect Taxes**	Interest Payments as% of Expenditures	Fiscal Index
1980	51.8%	11.8%	40.0%	12.1%	0.034
1981	46.1%	9.3 %	36.8%	11.4%	0.031
1982	48.3%	10.5%	37.8%	12.6%	0.031
1983	44.7%	9.3%	35.3%	12.8%	0.031
1984	45.3%	9.2%	36.1%	13.5%	0.032
1985	44.3%	8.5%	35.8%	13.7%	0.031
1986	44.6%	7.8%	36.8%	14.3%	0.034
1987	44.5%	7.4%	37.1%	14.7%	0.033
1988	44.9%	6.6%	38.3%	16.5%	0.034
1989	45.9%	8.2%	37.7%	18.0%	0.030
1990	46.6%	7.3%	39.3%	19.1%	0.028
1991	45.7%	7.3%	38.4%	20.4%	0.023
1992	47.9%	9.7%	38.2%	23.9%	0.018
1993	49.0%	10.9%	38.0%	25.3%	0.012
1994	40.8%	9.6%	31.3%	25.9%	0.003
1995	42.2%	11.5%	30.7%	27.4%	0.004
1996	48.6%	13.2%	35.4%	28.1%	0.007
1997	49.9%	13.5%	36.4%	29.6%	0.005
1998	41.1%	11.7%	29.4%	28.3%	0.000
1999	37.4%	11.5%	25.9%	27.9%	-0.00
2000	43.2%	13.9%	29.2%	30.3%	-0.004
2001	41.8%	15.0%	26.9%	30.5%	-0.001
2002	36.9%	13.4%	23.5%	29.6%	-0.006
2003	40.6%	15.1%	25.5%	28.6%	-0.03
2004	42.0%	15.9%	26.0%	28.1%	-0.02

*Direct Taxes= Income+Corporate Taxes
**Indirect Taxes= Excise+Customs Duties
Source: Reserve Bank of India

Table 8: Selected Components of Expenditure in the States and Centre of India

	Interest Payments as% of Total Expenditure		Development Expenditure as% of Total Expenditure		Capital Expenditure as% of Total Expenditure	
Year	State	Centre	State	Centre	State	Centre
1981	5.4%	11.4%	70.4%	57.5%	34.7%	36.7%
1982	5.7%	12.6%	71.4%	52.2%	32.2%	39.0%
1983	5.9%	12.8%	71.8%	50.7%	29.6%	39.1%
1984	5.9%	13.5%	71.5%	51.4%	29.0%	37.4%
1985	6.2%	13.7%	70.1%	59.6%	28.9%	36.5%
1986	6.6%	14.3%	70.7%	61.2%	27.0%	35.6%
1987	7.9%	14.7%	71.1%	54.8%	26.5%	35.1%
1988	8.2%	16.5%	70.9%	51.9%	24.7%	32.4%
1989	8.8%	18.0%	70.0%	50.9%	22.1%	31.6%
1990	9.4%	19.1%	69.2%	56.9%	21.6%	30.9%
1991	9.5%	20.4%	69.6%	54.3%	21.2%	30.2%
1992	10.1%	23.9%	69.1%	51.8%	20.1%	26.1%
1993	11.1%	25.3%	67.5%	51.9%	19.4%	24.4%
1994	11.7%	25.9%	66.4%	49.6%	18.8%	23.7%
1995	12.0%	27.4%	64.6%	50.1%	20.5%	24.0%
1996	12.4%	28.1%	64.7%	46.1%	18.3%	21.5%
1997	12.6%	29.6%	65.1%	45.6%	16.7%	20.9%
1998	13.2%	28.3%	63.7%	46.5%	18.2%	22.3%
1999	13.5%	27.9%	61.8%	47.7%	17.4%	22.5%
2000	14.4%	30.3%	59.7%	42.1%	16.9%	16.4%
2001	14.9%	30.5%	60.6%	41.4%	16.0%	14.7%
2002	16.1%	29.6%	58.9%	42.5%	17.5%	16.8%
2003	16.8%	28.6%	57.1%	44.6%	17.6%	15.4%

Source: Reserve Bank of India,RBI statistics

Table 9: Dependent Variable:Capital Outlay as a Percentage of GDP

	Center	States
Tax Receipts by GDP	0.33 (2.4)	0.34* (10.3)
Interest Payments by GDP	-0.10 (-.92)	-1.01* (-8.12)
Tax Receipts by GDP X Lib	-0.19 (-.60)	0.02 (0.14)
Interest Payments by GDP X Lib	-0.34 (-.57)	1.07* (6.19)
Liberalization	0.02 (0.54)	-0.02 (-1.5)
N	32	32
Adjusted R-squared	0.76	0.83

*= signficant at the 1% level, t statistics in parentheses

Table 10: Dependent Variable:Development Outlay as a Percentage of GDP

	Center	States
Tax Receipts by GDP	2.99 (2.35)	2.05** (13.6)
Interest Payments by GDP	-0.58 (-.72)	-1.76* (-3.11)
Tax Receipts by GDP X Lib	-4.06 (-2.46)	-0.73 (3.11)
Interest Payments by GDP X Lib	-4.5 (-1.92)	1.5 (1.96)
Liberalization	0.46 (2.8)	0.02 (0.04)
N	32	32
Adjusted R-squared	0.76	0.89

*= signficant at the 1% level, t statistics in parentheses

Table 11: Changes in Domestic Regulations for Capital Market

Element	1992	2003
Regulation	Central Government Oversight	Securities Exchange Board of India (SEBI)
Intermediaries	Some regulated intermediaries (stock brokers, authorized clerks)	A variety of specialized intermediaries emerged.They are registered and regulated by SEBI (also by SROs). They as well as their employees follow a code of conduct and are subject to a number of compliances.
Access to Market	Granted by Central Government.	Eligible issuers access the market after complying with the issue requirements.
Pricing of Securities	Determined by Central Government.	Determined by Market either by the issuer or the investor.
Access to International Market	None.	Corporates allowed to raise ADRs/GDRs. International financial institutions allowed to trade.
Corporate Compliance	Few rules.	Emphasis on disclosure.
Mutual Funds	Restricted to public sector.	Open to private sector
Anonymity in Trading	None.	Complete.
Form of Settlement	Physical.	Mostly electronic.
Derivatives Market	Absent.	Well developed.

Table 12: Assets of Scheduled Commercial Banks and Market Capitalization at BSE as percent of GDP

at end of	(I)Assets of SCBs	(II)Market Capitalization at BSE	(II)/(I)
Dec-85	46.8	7.40	15.2%
Mar-91	56.3	16.0	28.4%
Mar-92	52.9	49.5	93.5%
Mar-93	51.6	28.2	54.7%
Mar-94	52	42.8	82.3%
Mar-95	51.6	43.1	83.5%
Mar-96	52.3	44.5	85.2%
Mar-97	50.9	34.1	66.9%
Mar-98	54.4	37.0	67.9%
Mar-99	56	30.9	55.3%
Mar-00	59.1	46.8	79.3%

Note: Assets of scheduled commercial banks includes liquid reserves, loans, investments and other assets. SCB=Scheduled Commercial Bank, BSE=Bombay Stock Exchange.
Source: Reserve Bank of India and Bombay Stock Exchange.

Table 13: Percentage of Financial Assets of Household Sector Accounted for by:

Year	Shares and Debentures	Units of UTI	Total
1972-1975	0.4%	0.6%	1.0%
1975-1980	1.5%	0.4%	1.9%
1980-1985	3.3%	0.7%	4.0%
1985-1990	3.9%	1.1%	5.0%
1990-1995	8.7%	1.5%	10.2%
1995-2000	5.1%	1.9%	7.0%
2000-2003	4.0%	2.4%	6.5%

Source: Author's Calculation based on RBI statistics.

Table 14: Percentage of Financial Assets of Household Sector Held as:

Year	Shares and Debentures	Units of UTI	Total
1991	10	6.9	16.9
1992	10.9	14.6	25.5
1993	12.6	8.6	21.2
1994	10.6	5	15.6
1995	11.2	3.2	14.4
1996	8.4	0.2	8.6
1997	4.7	2.7	7.4
1998	3	0.4	3.4
1999	2.8	1	3.8
2000	7.9	0.9	8.8
2001	5	-0.4	4.6
2002	3.8	-0.7	3.1
2003	2.8	-0.6	2.2

Source: Handbook of Indian Statistics,2004

Table 15: Investment by FIIs

Year	Number of FIIs	Net Investment (Rs. Crore)	Net Investment (US$ Millions)	Cumulative Net Investment ($ US Millions)
1993-94	158	5,126	1,634	1,638
1994-95	308	4,796	1,528	3,167
1995-96	367	6,942	2,036	5,202
1996-97	439	8,574	2,432	7,634
1997-98	496	5,957	1,650	9,284
1998-99	450	-1,584	-386	8,898
1999-00	506	10,122	2,339	11,237
2000-01	527	9,934	2,159	13,396
2001-02	490	8,755	1,846	15,242
2002-03	502	2,689	562	15,805
2003-04	540	45,767	9,950	25,755
Total		1,07,089	25,755	25,755

Table 16: Net Resources Mobilized by Mutual Funds(Rs. crore)

Year	UTI	Bank-Sponsored Mutual Funds	FI-Sponsored Mutual Funds	Private Sector Mutual Funds	Total
1980-81	52.1	-	-	-	52.1
1981-82	157.4	-	-	-	157.4
1982-83	166.9	-	-	-	166.9
1983-84	330.2	-	-	-	330.2
1984-85	756.2	-	-	-	756.2
1985-86	891.8	-	-	-	891.8
1986-87	1261.1	-	-	-	1261.1
1987-88	2059.4	250.3	-	-	2309.7
1988-89	3855.0	319.7	-	-	4174.8
1989-90	5583.6	888.1	315.3	-	6786.9
1990-91	4553.0	2351.9	603.5	-	7508.4
1991-92	8685.4	2140.4	427.1	-	11252.9
1992-93	11057.0	1204.0	760.0	-	13021
1993-94	9297	148.1	238.6	1559.5	11243.2
1994-95	8611	765.5	576.3	1321.8	11274.6
1995-96	-6314	113.3	234.8	133.0	-5832.9
1996-97	-3043.0	5.9	136.9	863.6	-2036.7
1997-98	2875	236.9	203.4	748.6	4063.9
1998-99	170	-88.3	546.8	2066.9	2695.4
1999-00	4548	335.9	295.5	16937.4	22116.8
2000-01	322	247.8	1272.8	9292.1	11134.7
2001-02	-7284	862.8	406.8	16134.1	10119.7
2002-03 P	-9434.1	1033.4	861.5	12122.2	4583.0
2003-04 P	1049.9 *	2634.6	1126.7	42872.8	47684.0

P. Provisional
Source:RBI

Table 17: Distribution of All Households in Instruments by Income Class (% of all households)

Income per month (Rs.)	UTI Scheme	Mutual Funds	Fixed Deposit	Bonds
Upto 2500	2.4	1.8	65.0	3.4
2501-5000	6.4	4.3	81.3	5.3
5001-10000	19.0	12.0	88.3	11.1
10001-15000	31.9	17.9	90.2	16.0
Above 15000	33.9	20.7	93.8	21.5
Urban	40.6	31.0	92.7	33.4
Rural	13.8	14.0	92.3	14.3

* Since one household may invest in more than one instrument, percentage distributions of households will add up to more than 100.
Source: SEBI-NCAER Survey of Indian Investors, June 2000.

Table 18: Share of Different Categories of Shareholders in Market Capitalization in 2003

	Rs. Crore	Percentage
MCAP of 2,507 Non-Government Companies	4,40,160	100%
Owned by:		
1) Indian and Foreign Promoters	2,10,597	47.5%
2) Institutional Investors	1,08,281	24.6%
a) FII's	53,741	12.2%
b) Banks and Financial Institutions	30,506	6.9%
c) Mutual Funds	24,033	5.4%
3) Private Corporate Bodies	17,852	3.9%
4) General Public	79,086	17.9%

Source: Rao, 2004

Table 19: Central Business District - Capital Value Rs.Per Square Foot

Year	Mumbai,Nariman Point	Delhi	Bangalore
1990	3000	3500	750
1991	3500	3500	800
1992	6000	4500	950
1993	7000	5200	1500
1994	15000	15000	1500
1995	25000	18000	2050
1996	22000	13000	2000
1997	20000	13000	2000
1998	18000	11000	2000
1999	15000	9000	2250
2000	17000	8500	3000
2001	13000	8200	3000
2002	11000	8200	3000
2003	10000	8200	3500
2004	10000	8200	3800

Source: CB Richard Ellis, India Market Brief, Various Issues.

9 Appendix

The main body of this paper was written in 2005. A number of significant changes have occurred in financial policy in India since that period. Detailing these is beyond the purview of this appendix. The question of how to modernize the financial system, to make it more efficient and also more equitable has been debated in several fora. The interested reader is referred to Mohan, 2011 , Shah et al, 2011 or Prasad and Rajan, 2008 for for an overview of these. This noted, 2005 constitutes in some sense a propitious break point in the narrative for the relationship between financial reform and distribution, since that year marked the beginning of two important changes. First, in terms of the issues of financial inclusion that year saw the explicit re-adoption of financial inclusion as a stated goal of the RBI and policy makers in the liberalization period. These proposals were meant to address distributional concerns at the lower end of the income distribution. Second, trends that were nascent in 2005, especially with regard to inward portfolio flows gathered strength and became the core of the policy debate in the latter half of the decade. This in turn had impacts through the capital market circuit on increasing wealth and concentration at the top end of the distribution. I briefly go over these changes in what follows.

9.1 Financial Inclusion and Debt Relief

Following its Mid Term Monetary Policy review paper in 2005, the RBI began to promote efforts towards financial inclusion in 2005. It recommended that all national banks promote financial inclusion as a prime objective in their plans and also detailed some recommendations as to the ways this could be achieved. Perhaps most interestingly, inclusion here has seen a subtle shift away from being about direct provisioning of credit by the banks to suggesting that banks offer better and more tailored financial products. As such, the focus has moved away from directed lending to providing some new products such as no-frills accounts, simplifying registration norms, providing credit thorough Kisan Credit Cards and General Credit Cards and the like. Each one of these attempts to promote inclusion by limiting the amount of documentation required for inclusion and to allow farmers and rural populations access to credit while allowing banks to retain some autonomy. Under these schemes, expansion into rural branches is meant to be voluntary and credit is driven by the demand side. In some cases, there is an attempt to extend supply to small areas (the Swabhiman scheme provides plans to reach the underpopulated hinterland areas). Similarly, there have been attempts to increase savings vehicles for informal set or workers (for example the national informal sector pension schemes and the like). There is little evidence that these have been successful in increasing inclusion significantly and therefore ameliorating the situation of those at the bottom. While some schemes have had larger uptake, they have simply been too recent to make a clear assessment.

Where there has been improvement on the other hand is in the situation of indebtedness of rural farmers. The Agricultural Debt Waiver and Debt Relief Program for Small and Marginal Farmers, cancelled the outstanding debts of 45 million rural households across the country, amounting to approximately 1.7% of GDP. In perhaps the clearest summary of the

situation, Kanz 2012 (http://documents.worldbank.org/curated/en/2012/11/16920501/debt-relief-development-evidence-indias-bailout-program-highly-indebted-rural-households) shows that the reduction in the debt levels of marginal farmers has been significant and persistent, although this has not lead to increased investment.

9.2 Capital Account Management

In the main body of the paper, I discussed the trend whereby the health of the stock market began to be seen as the key indicator of the health of the economy in the early 2000s. This meant to some extent, exposing Indian policy making to the caprices of global financial capital movements. Since 2005 this has intensified and the management of foreign institutional and portfolio flows has become a more pressing concern. The BSE index has more than doubled since 2005 to sit at around 19000 in 2013. This in turn has been driven in part by the massive inflow of capital from abroad.

In the period from 2005-2008, pressures to completely open the capital market continued to gather apace. The governorship of YV Reddy was criticized as being antediluvian and ad hoc, since full capital account convertibility was always seen to be the end goal. The implosion of the US financial system in 2008 and the concomitant change in attitudes towards capital account liberalization vindicated, however, the stance of gradualism and pragmatism adopted by Indian policy makers. Most recently, the Governor of the RBI reiterated the stance of gradualism and pointed towards the probability that both quantitative and price controls on capital flows would be maintained (Rao 2013, available at http://www.bis.org/review/r130418c.pdf).

This noted, the stock market, for all its oversize grip on policy makers imagination caters to a very small percentage of the domestic population. Estimates suggest that about 2-3 % of the population have any holding interest in the stock market . Moreover, the major participants appear to be H High Networth Individuals (HNIs) and corporate customer while Institutional investors and proprietary traders account for about half of trading. As such, the importance of the stock market as an investment vehicle for the vast majority continues to be highly overplayed.

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