

Impact of Financial Sector Reforms on Economic Growth in India

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Abstract: The performance of the Indian economy in the last decade has been remarkable. This can be partly attributed to the multi-sector structural reforms, undertaken simultaneously in 1991, aimed at enhancing productivity, efficiency and international competitiveness of the economy. The reforms in the financial sector have been most effective. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated. The reforms have been undertaken gradually with mutual consent and wider debate amongst the participants and in a sequential pattern that is reinforcing to the overall economy. The financial markets have developed and are more integrated after the reforms, and regulatory and supervisory institutions have been set-up. The reforms, though slow paced initially but well synchronized, have begun to yield results. The economy has recorded consistently high growth rates, avoided any adverse impact from the South East Asian Crises, built substantial foreign exchange reserves, pre-paid some of its external debt and restructured its domestic debt.

Keywords: Financial Sector, Reforms, Economic Growth & India

Introduction

The term 'Finance' in our simple understanding is perceived as equivalent to money. It is, however, not exactly money, rather a source of providing funds for any particular activity. The word 'system' implies a set of closely inter-connected yet separate institutions, agents, practices, markets, transactions and so on working together to achieve some purpose. Financial System thus imply a set of complex and closely connected institutions, agents, practices, markets, transactions, claims and liabilities that work together to provide funds for different economic activities. Conceptually, financial system includes complex institutional arrangements for mobilizing financial surpluses from surplus units and transferring these to deficit spenders. These institutional arrangements includes all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets of various types and the organization as well as manner of operation of financial markets and institutions. A financial system helps to promote savings and appropriately allocate the available funds. It is concerned about money, credit, and finance: closely related, yet different from each other. Money refers to the current medium of exchange or means of payment. It also serves as a store of wealth and unit of account. It consists of coins, notes and deposits with banks withdraw able on demand. It is a liability of the banking system. Credit or loan is a sum of money lent by one party to another to be returned normally with interest. It is a liability of the holding public and asset for the lender/lending institution. Finance is monetary resources for funding any activity. It consists of debt and ownership funds of an economic entity. The financial system of any country typically comprises of financial institutions, financial markets, and financial instruments and services.

Financial Institutions are like business organizations involved in the sale purchase of financial assets and providing various financial services to the community. These can be classified on the basis of functions, geographical coverage, sector, scope of activity or type of ownership. An important classification is that between intermediaries and non-intermediaries. Intermediaries are the ones that mediate between those with budget surpluses and those who wish to run deficits. They buy primary securities and sell secondary securities that are in general far more acceptable to the surplus units. By transforming primary into secondary securities they embody innovations in financial technology whereby separate asset-debt preferences of lenders and borrowers are reconciled to the satisfaction of both parties. Lenders get access to a wide variety of secondary securities with lower risk, greater liquidity, lower associated transaction and information costs and a host of other services. Borrowers are benefited by availability of large pool of funds with greater certainty and relatively low rates of interest. An important question that comes to mind is how these intermediaries are able to offer the low risk secondary securities when they buy primary securities that are more risky. The answer lies in the law of large numbers, portfolio diversification, and services of professional management – all these become realizable only when operating on a large scale.

Intermediaries themselves can be further classified as bank (RBI, commercial banks, co-operative banks) and non-bank financial intermediaries (NBFIs). The distinguishing character of the banking mechanism lies in that –

1. They participate in economy's payment mechanism i.e. provide transaction services.
2. Their deposit liabilities constitute a major part of economy's money supply.
3. They can create deposits or credit, which is money.

Many non-banking institutions like LIC, UTI also act as intermediaries and are known as NBFIs. An important distinction between banks and NBFIs is that banks are subject to legal reserve requirements. They can advance credit by creating claims against themselves, while NBFIs can only lend out of resources put at their disposal by savers. The non-intermediary institutions like IDBI, NABARD do the loan business but their funds are not directly obtained from the savers. These have come into existence because of governmental efforts to provide assistance for specific purposes, sectors and regions. They are therefore also called non-banking statutory financial organizations (NBSFOs).

Financial Markets are a significant component of any financial system. These refer to the institutions or arrangements that facilitate the transactions in financial assets and credit instruments of different types as currency, cheques, bonds etc. The market may not have a precise physical location. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers etc. These markets can be classified in a variety of ways.

A. Based on maturity structure, we can talk of money market and capital market. Money market is a source of short-term funds (one year or less). It facilitates adjustment of liquidity amongst its participants. Examples: bill market, inter-bank call money market, working capital advances from commercial banks etc. Capital Markets deal in long-term and medium term claims. Examples: Stock market, government bonds market, financial institution credit. For long and medium term claims the maturity is more than a year but in a well-developed financial system secondary markets exist for most of such claims thus making them fairly liquid.

B. Based on type of securities traded: primary and secondary market. Primary market or new issues markets deal in new financial claims. Secondary markets deal in securities already issued. Although secondary markets do not contribute directly to the supply of additional capital, they do so indirectly by increasing the liquidity of primary securities.

C. According to the nature of instruments traded, these markets can be classified as debt, equity, or financial service markets. Debt market is where lenders provide funds to borrowers for some specified period at fixed interest rate. In equity market, ownership of tangible assets (such as houses or share of stock) is brought and sold. Financial services markets deal in services that enhance the working of debt and equity markets. Examples: safety deposit boxes, ATM transactions, brokerage services etc. No secondary market exists for financial services.

D. Organized and Unorganized markets – When financial transactions take place outside well-established exchanges or without systematic and orderly structure, in an informal way - it constitutes the unorganized markets. It is largely made up of indigenous banks, moneylenders, and activities not coordinated by RBI or any other authority. The formal sector constitutes the organized segment. It is subject to different types of regulations from the authorities from time to time.

III Financial Instruments and Services: The financial claims or instruments and services are many and varied in character because of diversity of motives behind borrowing and lending. Indeed the maturity and sophistication of a financial system is often gauged by the prevalence of a wide variety of assets and services to suit varied investment requirements of heterogeneous investors. This enables them to mobilize savings from as wide section of investing public as possible. Financial securities can be classified as primary (direct) and secondary (indirect) securities. Primary securities are financial claims against real sector units e.g. bonds, equities, bills etc. – i.e. backed by real investments. Secondary securities are claims issued by financial institutions against themselves to raise funds from public e.g. currency, bank deposits, insurance policies, post office deposits etc.

Role of Finance in Economic Growth

The relationship between finance and economic development is a long debated issue. There is a long list of economists who stress the importance of a sound financial system for economic growth. Schumpeter¹, the first modern economist to study the relationship regarded banking system as one of the two ingredients in the process of development. Gerschenkron² considers that banking sector plays a key role at certain stages of industrialization process. Goldsmith finds a positive relation between economic development and financial development. McKinnon, Shaw, Greenwood, Jovanovich, Levine, Allen, Gale all reiterate this view³. These economists thus suggest a ‘supply-leading’ financial development i.e. financial development precedes economic development; brought about through a conscious, deliberate policy by the authorities. The basic idea behind such promoted financial development is that it will help to accelerate the real rate of growth. The available literature points to a number of channels through which finance promotes growth:

- Increasing savings rate and therefore investment.
- Investment allocation
- Technical innovations
- Easing external financing constraints
- Improving corporate governance
- Reducing credit rationing

These lead to higher investment and/or increased investment efficiency that ultimately speed up the growth process. Thus, one of the views on linkages between financial development and economic growth is that the financial system plays an important role in promoting economic development. It helps in production, capital accumulation, and growth by encouraging more savings, mobilizing them to productive uses and allocating them amongst alternative uses and users. In every economy, there are surplus

sectors and deficit sectors. Household as a sector is the surplus sector which has more funds than it wishes to spend. Production firms on the other hand are deficit units that need much more than their internal finances. The financial system encourages the surplus sectors to save more and put the savings in financial assets. These savings can then be made available to enhance production activities. The financial system promotes savings by providing a wide range of financial assets and services to suit the diversified needs of numerous savers. More developed the financial system more options will be available to suit the needs of different savers. Surplus funds will then flow more and more to the financial system rather than in tangible physical assets. These funds can then be made available to those who need them for productive investment. An efficient financial system is in a position to improve the allocation of available funds by favoring more productive and socially desirable activities. When increased funds are available, more research activities and hence innovations become possible. Also the need for external funds is greatly reduced or even eliminated. These specialized financial institutions even provide suggestions and advice to improve the functioning and efficiency of production units. All these above services are instrumental for enhancing production, capital formation, and growth.

Evolution of the Indian Financial System

Pre-Independence: The Indian financial system, on the eve of planning, was immature and partially rudimentary reflecting the underdeveloped state of the economy. Some sort of banking business had begun during the early part of the 19th century, but it experienced little growth that too in the early part of 20th century. It was concentrated in the hands of a few large banks, though qualitatively, the services of small banks were of great importance. Most popular form of bank credit was cash credit and overdrafts. Bill finance was not much prevalent. The indigenous bankers dominated the financial scene. They financed trade, acted as government bankers, mint-managers, and moneychangers, and managed transfer of funds. Although co-operative banking began during 1920s, it made little progress, particularly in relation to demand for funds in the agricultural sector. Post offices saving bank deposits and small saving certificates have been one of the oldest mediums for community savings. Life insurance business on sound lines began in the second decade of the 20th Century.

The first stock exchange was established in 1887. The increased pace of industrialization due to two world wars, protection to domestic industries in fiscal measures, resulted in active new issue markets and stock exchanges. The practice of companies accepting deposits directly from the public was well developed even before 1950. The market for government securities and treasury bills had also expanded phenomenally before 1950. The price of government securities showed significant fluctuations before 1935. The setting up of the Reserve Bank of India (RBI) in 1935 facilitated the pursuit of policy of stable government security prices after that year. There were wide inter-bank and interregional differences in the rates of interest. Compared to the position after 1950, the level of interest rate even in the organized sector during major part of the period before 1950 was quite high. They declined only after 1933 and then were maintained at relatively low levels.

Post Independence: With the initiation of planned economic development in 1951, the Indian financial System entered a new phase of development. Organization: The heavy industrialization strategy with a major role to the public sector greatly conditioned the evolution of the financial system in the independent India. It had a significant bearing on the institutional structure and regulatory framework. Public control was extended over financial institutions partly through nationalization of existing institutions but mainly through establishment of new institutions in the public sector – the development financial institutions and unit trusts that dominated the Indian financial system for quite some time. To ensure that private industry operated on the desired path laid down by the five-year plans; restrictions were imposed on investment institutions governing their investments in the private sector. Public sector financial institutions participated in the management and control of enterprises to which finance was provided.

After Liberalization: With liberalization in the nineties the organization of Indian Financial System is undergoing a major transformation in terms of its ownership, management, and control of financial institutions, their operations, institutional pattern, regulatory framework etc. One important aspect relates to the entry of new private sector (including foreign) banks and other financial institutions, public sector financial institutions getting privatized, application of prudential norms in accounting of income, asset classification, provisioning, and capital adequacy.

Growth and innovations: On the whole, the Indian Financial System has grown enormously since 1950 in terms of its size, innovations, diversity, complexity, and sophistication. Although banking system still remains the largest and most important part of the Indian Financial System, other financial institutions have also grown and now occupy an important place in the financial structure. The securities market has emerged as an important mechanism for allocating resources in the economy. Stock Exchange Board of India (SEBI) an autonomous body – provides an integrated and focused regulation and helps development of the capital market. There has also been a transformation in the role of various financial institutions. The distinction between banks and other financial institutions has become blurred and the Indian Financial System is moving in the direction of Universal banking and financial conglomeration. It has become much more integrated than ever before. The earlier divisions such as organized and un-organized markets, or busy and slack seasons have become very blurred now.

Objectives

The work is a comparative study of pre and post liberalization period. It aims to achieve the following objectives:

To study the reforms taken place in the financial sector

Data and Methodology

As just discussed four time-series variables form a part of the final regression analyses to be undertaken. Some other variables were considered but finally dropped for different reasons. The included variables are the average annual rate of growth of real gross Domestic product at factor cost (EG), Institutional credit to the private sector (CR)/GDP, market capitalization ratio (MCR)101 and rate of gross domestic capital formation. Most of the data has been obtained from 'Handbook of Statistics on Indian Economy, Oct 2008 published by RBI. Gives annual growth rate of real GDPFC (1999-2000 series) from 1950-51 to 2007- 08 in percentage terms. This series is used for the variable EG.

Data for CR is calculated from magnitudes from table 47 (non-food credit of SCBs), table 66 (credit advanced by non-scheduled commercial banks (non SCBs), 68 (Credit advanced by State Co-operative banks maintaining accounts with RBI) and 85 (Financial assistance disbursed by all financial institutions). Here, some clarifications are required. Data on bank credit exclude the impact of mergers on May 3, 2002 and the impact of conversion of a non-banking entity into banking entity on 11th October 2004. In context of financial assistance provided by the development financial institutions the state level institutions (SFCs and SIDCs) are not included because in respect of these data is available only up to 2004. From All India Financial Institutions (AIFIs) six FIs are included for which data is available till 2007. These are SIDBI, LIC, GIC, TFCI, IVCF and IFCI. SIDBI commenced its operations in April 1990, TFCI in Feb. 1989 and GIC102 in 1973. SCICI Ltd. was merged with ICICI Ltd. with effect from April 1996 and ICICI Ltd. was merged with ICICI bank in 2002-03, ceasing to be an AIFI. UTI has been organized into two separate institutions, ceasing to be an AIFI. For this reason SCICI Ltd., ICICI Ltd. and UTI have not been included in the analyses to maintain the comparability of data.

Financial Sector Reforms

When India became independent in 1947, it was a backward, primarily agrarian, stagnant, and low-income economy. Institutional set up and infrastructure was terribly weak. We started with a centrally planned process of economic development but the progress for a period of over four decades had been far from satisfactory. Whether looked at from an economic angle or a social view point there were problems of various kinds. On the whole, slow and uneven progress had taken place. In the beginning of 1990s India was faced with serious fiscal and financial problems. It had to approach the World Bank and other international financial institutions for financial assistance. It was against this backdrop, that wide-ranging reforms, encompassing all sectors of the economy were initiated. This chapter outlines the need for reforms in the financial sector and presents a summary of these reforms.

Need For Reforms

The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed economy framework, where the government had a pre-dominant role in economic activity. In order to facilitate the large borrowing requirements of government, SLR was frequently revised upwards and maintained at high levels. Interest rates on government securities were artificially too low, unrelated to the market conditions. The government securities market could not develop. The provision of fiscal accommodation through adhoc treasury bills (at 4.6%) led to high levels of monetization of fiscal deficit. To check the monetary effects, CRR was frequently revised upwards. The CRR and SLR on the eve of the reforms were quite high and the associated interest rates low.⁷ The environment in the financial sector in those years was characterized by segmented and under developed financial markets with paucity of instruments.

The existence of a complex structure of interest rates arising from economic and social concerns of providing concessional credit to certain sectors had resulted in cross subsidization which implied that higher rates were charged to nonconcessional borrowers. The regulation of lending rates led to the regulation of deposit rates to keep the cost of funds to banks at reasonable levels. The system of administered rates had led to multiplicity and complexity of interest rates. On the whole the directed and concessional availability of bank credit with respect to certain sectors resulted in distorting the interest rate mechanism and adversely affected the viability and profitability of the banks. Lack of recognition of the importance of transparency, accountability, and prudential norms in the operations of banking system led to a rising burden of non-performing assets.

The Reforms of 1991 (NCR-I)

On the whole, banks, other financial institutions, and financial markets were all operating in a highly controlled and regulated environment. Some steps towards liberalization were taken during 1980s. In 1991, wide ranging economy wide reforms were undertaken. In August 1991 the government of India appointed a committee on the financial system under the chairmanship of Shri M. Narasimham, a former governor of the RBI. The Committee was to examine the existing structure of the financial system and its various components and to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions.

The Second Generation Reforms 1998 (NCR-II)

In the first phase of reforms as discussed above the focus had been on arresting the qualitative deterioration in the functioning of the system. Most of the recommendations were promptly implemented and a measure of success achieved. In the meanwhile, major changes had been taking place in the domestic economic and institutional scene, coinciding with the movement towards global integration of financial services. These developments re-enforced the importance of building a strong and efficient financial system. In 1998, therefore, the situation was reviewed and there were the second-generation reforms. These could be looked at in terms of 3 broad inter related issues:

Actions that need to be taken to strengthen the foundations of the banking system
Streamlining procedures, upgrading technology and human resource development, and
Structural changes in the system

The major recommendations included increase in CRAR to 10% by 2002, new guidelines for asset classification, reduction in net NPAs to below 3% (0% for those banks with international presence), elimination of subsidy element in priority sector (redefined) lending, full disclosure of information, revised and regularly updated operational manual by banks and consolidation and convergence of the financial system, a system for recruiting skilled manpower from the open market, re-deployment of surplus staff, flexibility to determine managerial remuneration, achieving rapid induction of information technology, allowing foreign banks to set up subsidiaries or joint ventures in India, evolution of a risk management system, greater internal controls, transparency and market discipline, legislative steps etc.

Indian Financial Markets

In the preceding chapters, the focus of attention had been the financial institutions. This chapter is devoted to a detailed study of the financial markets. Starting with the importance of financial markets in an economy, it then brings out the organization and the structure of these markets in India and in what way they have been affected by the reforms undertaken in the financial sector.

Importance

From a financial stability perspective it is necessary to have a financial system whereby both financial institutions and financial markets play an important role. Stock market is an important and growing ingredient of the financial market, more so in developing countries. Well-developed stock markets may be able to offer different kinds of financial services from financial institutions and a different kind of impetus to investment and growth⁸¹. Increasing stock market capitalization (SMC) may improve an economy's ability to mobilize capital and diversify risk. On one hand, there are models that emphasize the tensions between bank based and market based systems⁸², on the other there exist a number of studies on financial development and economic growth focusing on complementarily hypothesis. One such study suggests that stock markets and financial intermediaries have grown hand in hand in the emerging market economies. Some other studies also find that the levels of banking development and stock market liquidity exert a positive influence on economic growth. Levine and Zervos (1998) show that initial level of stock market liquidity and banking development are positively and significantly co-related with future rates of economic growth, capital accumulation, and productivity growth.

The capital market fosters economic growth in various ways such as by augmenting the quantum of savings and capital formation and through efficient allocation of capital that in turn raises the productivity of investment. It also enhances the efficiency of a financial system as diverse competitors vie with each other for financial resources. It adds to the financial deepening of the economy by enlarging the financial sector and promoting the use of innovative, sophisticated, and cost effective financial instruments, which ultimately reduce the cost of capital. Well-functioning capital markets also impose discipline on firms to perform.

The Capital Market in India: Organization and Structure

The stock market in India consists of 19 stock exchanges spread all over the country. The number increased from nine in 1979-80 to 22 in 1993-94 and remained almost constant thereafter. In the year 2007-08 it declined to 19. Of these exchanges, two of them opened up to derivative trading i.e. futures and options contract in 1999-2000.

Infrastructure of stock market: The number of brokers (including corporate brokers and sub-brokers) operating in these exchanges adds up to more than 55,000. Besides these there are over 1300 foreign institutional investors, hundreds of depository participants, portfolio managers and merchant bankers and so on. Numerous underwriters, debenture trustee, venture capital funds, registrars to issue, and mutual funds support these. India has now the largest number of organized and recognized stock exchanges in the world. All of them are regulated by SEBI. They are organized either as voluntary non-profit making associations or public limited companies or companies limited by guarantee. All stock exchanges have two parts:

- The new Issues market (NIM) or the primary market (PM).
- The Secondary market (SM).

While the NIM supplies additional capital to companies, the SM does not directly supply fresh capital, but encourages investors to invest more in industrial securities by making them more liquid. It provides facilities for continuous and regular trading in these securities.

The Bombay Stock Exchange (BSE) is the apex stock exchange in India. It is the oldest market and has been recognized permanently, while recognition for other exchanges is renewed every five years. It is biggest in size in terms of amount of fresh capital raised, secondary market turnover and capitalization and the total listed companies. Its business is no larger confined to Mumbai alone; at the end of 1997, there were 100 other cities in which it had set up its business. Apart from BSE, there are two other stock exchanges in Mumbai, viz, the National Stock Exchange of India Ltd. (NSE) and Over-the-Counter Exchange of India Ltd. (OTCE). The NSE has a fully automated electronic screen based trading system. It has two separate segments. The Wholesale Debt Market Segment (WDMS) that caters to banks, financial institutions and other institutional participants and deals in PSU bonds, units, treasury bills, government securities, call money, commercial paper, certificate of deposits etc. (b) the Capital Market Segment (CMS) which deals in equities, convertible debentures etc. The NSE allows its members to trade from their offices through a communication network. By the end of 1997, it had spread its business in 200 cities with more than 1000 terminals.

The Reform Measures

Although the capital market in India has a long history, during most part, it remained on the periphery of the financial system. Various reforms undertaken since the early 1990s by the SEBI and the GOI⁸⁷ have brought about a significant structural transformation in the Indian Capital market. The reforms have been implemented in a gradual and sequential manner, based on international best practices, modified to suit the country's needs. The reform measures were aimed at

- Creating growth enabling institutions
- Boosting competitive conditions in the equity market through improved price discovery mechanism
- Putting in place an appropriate regulatory framework
- Reducing the transaction costs
- Reducing information asymmetry, thereby boosting the investor confidence.

Institutional development was at the core of the reform process. SEBI that was initially set up (in 1988) as a non-statutory body was given statutory powers in 1992 for regulating the securities markets. It was given the twin mandate of protecting investors' interests and ensuring the orderly development of the capital market. The most significant reform in respect of the primary capital market was the introduction of free pricing. All companies are now able to price issues based on market conditions. The norms for public issues were made stringent in April 1996 to prevent fraudulent companies from accessing the market. Greater disclosure now required has enhanced transparency, thereby improving the level of investor protection. Trading infrastructure in stock exchanges has been modernized and trading and settlement cycles successively shortened. This greatly reduces the risk associated with unsettled trades due to market fluctuations.

The setting up of National Stock Exchange of India Ltd.(NSE) as an electronic trading platform set a benchmark of operating efficiency for other stock exchanges in the country. The establishment of National Securities Depository Ltd.(NSDL) in 1996 and Central Depositing Services (India) Ltd.(CSDL) in 1999 has enabled paperless trading in exchanges. This has also facilitated electronic transfer of securities and eliminated the risks to the investors arising from bad deliveries in the market, delays in share transfer, fake and forged shares, and loss of scripts. The electronic fund transfer (EFT) facility combined with dematerialization of shares has created a conducive environment for reducing the settlement cycle in stock markets. The improvement in clearing and settlement system has brought about a substantial reduction in transaction costs. Several measures were also undertaken to enhance the safety and integrity of the market. These include capital requirements, trading and exposure limits, daily margins, and setting up of trade/settlement guarantee fund to ensure smooth settlement of transactions in case of default by any member. Some of the other important reforms

Impact of Reforms

Ever since the reform process began in early 1990s, the Indian Capital Market has witnessed significant qualitative and quantitative changes. Substantial improvement in terms of various parameters as size of the market, liquidity, transparency, and efficiency has taken place. The changes in regulatory and governance framework have brought about an improvement in investor confidence. Together with these developments on the positive front it also needs to be noted that with opening up to the foreign sector the stock market has become much more volatile and vulnerable to foreign disturbances. The studies relating to the stock markets often evaluate the developments with regard to size, liquidity, and volatility. This study has examined the trends in these indicators on the basis of whatever data is available. The data has been obtained from 'The Handbook of Statistics on the Indian Securities Market, 2008.' Where any other data source is used it has specifically been mentioned. In most cases the pre-liberalization data is not available. Therefore, rather than comparing the pre and the post liberalization trends, the study has examined the trends after liberalization. This gives a picture of the stock market after the reforms.

Financial Development and Economic Growth

The basis objective of this study is to establish whether the reforms undertaken in the financial sector of the economy have had any influences on the country's economic growth. In the previous chapters, it has been shown that after the reforms, substantial development has taken place in the financial sector in terms of a number of selected indicators. Both institutions and markets have witnessed remarkable progress in the post reform period. Savings and investment during the post reform period have also increased at much higher rates in comparison to the pre-reform period. What now remains to analyze is that how far these developments of the

financial system have led the high rates of capital formation and more importantly economic growth. This will depend on the extent to which financial development in India is related to country's economic growth. This precisely is the subject of this chapter.

The Determinants of Growth

Just as there is no consensus on the role of financial development in economic growth, there also is lack of unanimity on the key determinants of growth. Here too, as in case of finance–growth relationship, differences would exist between different countries and at different times. Particular variable say government expenditure can be a drag on growth in one country and a key stimulating factor in another. In a same country it may vary across time periods. Traditionally, growth models have focused on capital accumulation as the prime determinant of growth. The concept of (incremental) capital output ratio was very important. Traditional models single out investment as the only factor affecting growth and contend that output grows in a fixed proportion in relation to the incremental capital stock. Then, financial intermediation or any other variable for that matter would have no place in determining growth. Such rigid relationships between capital and output growth have been proven to be far from true. Economic growth depends for sure on factors more than just capital. But what these factors are? The answer has varied from time to time and place to place. At different times and in view of different economists, various determinants of growth are changing in importance.

The differences in rates of growth of various economies were in the past attributed to differences in rates of physical capital accumulation. At one time government expenditure and governance in the economy were considered of prime importance in explaining differing rates of growth across economies. Finance or availability of funds for production activities and overall development of the financial system has also been considered as explaining differences in growth. Then lately, it has been argued that it is not only physical capital formation but also human capital formation that is crucial to the growth process. Going into a literature survey for empirical results on all these factors would be diverging away from the main point. The above discussion however is important as it points to various determinants of economic growth being discussed in literature from time to time. In today's globalized world some international factors may also become important. In totality, thus, economic growth depends on a number of qualitative and quantitative factors. The important ones are physical capital accumulation, quality and quantity of labor force and / or work force, development of human resources, foreign capital, finance availability, government expenditures of productive nature, governance, and so on. Some demand factors may also be important in stimulating growth.

Positive Developments

1. The Insolvency and banking code (IBC) (amendment) ordinance 2017 bill has been passed by Rajya Sabha and it is expected to strengthen banking sector.
2. The Government passed the banking regulation (amendment) bill 2017 which will empower RBI to deal with NPA's in the banking sector.
3. High net interest margins, along with low NPA levels, ensure healthy business fundamental.
4. Basel – III norms put forward and aimed to strengthen bank's transparency and disclosures.

Conclusion

When the stock market is going good it is often noted that IPOs (initial public offerings of bonds) are oversubscribed and the corporate firms are easily able to raise fresh capital. It seems, in case of India, such a role is limited and overshadowed by speculative trading so that funds are diverted away from productive to unproductive channels, thereby having a negative influence on growth. Within the stock market trading activity, it is also noted that the shares trading in high volumes are majorly momentum shares and rarely those of companies with a promising future. Thus, stock market in Indian Economy has had negative impulses on capital formation and to some extent on economic growth. The effect in reverse direction i.e. of economic growth on stock market is also negative. A large proportion of funds in the Indian Securities market come from foreign institutional investors. When growth momentum is build into an economy more of such funds often go to long term productive rather than speculative activity. A point to note here is that market capitalization is directly influenced by both volumes and price of shares traded. With high growth rates, within securities market, more money flows into long term investment in shares of companies with sound credentials rather than speculative investment. With long term investment funds are siphoned out of circulation. Moreover, it is speculative trading that pushes up stock prices too high (or too low). With investment trading the price increases are moderate and so are the trading volumes. One other factor may be important here. With economic growth doing well some of the corporate firms with promising project in hand may liquidate large part of their stock holdings to pump in fresh money into their business. Such block sales may have dampening effect on the stock prices and therefore on market capitalization.

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