

**THE NEW ECONOMIC POLICY AND
FINANCIAL LIBERALIZATION**

by

Dr. Prasanna Chandra*

**Indian Institute of Management
Bangalore**

**Professor, Indian Institute of Management, Bangalore*

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An Abstract

In recent times, some initiatives to liberalize the financial sector have been taken; some more measures need to be taken. In this monograph, the author discusses several measures to make the financial sector improve the economic performance of the country. These liberalization measures must be carefully phased-out over a period of time so that there is no destabilization. Therefore, financial liberalization must be accompanied, or even preceded, by reduction in trade deficit, containment of fiscal deficit, control of inflation and improvement in legal, regulatory and accounting foundations. If these changes are not effected, financial liberalization per se may not accomplish much.

The new economic policy seeks to narrow trade deficits, contain fiscal deficits, provide greater scope for private initiative, rely more on market signals, reduce governmental controls in the economy, curtail subsidies, stimulate foreign direct investments, and strengthen international linkages.

In the wake of the new economic policy - and to an extent even earlier - some initiatives have been taken to liberalize the financial sector. Much more, however, needs to be done so that the financial sector responds to the needs of the real sector and redounds to improve economic performance. This monograph explores the measures that may be taken in the direction of financial liberalization.

Reduce the scale of directed credit

In order to comply with the statutory liquidity ratio and cash reserve ratio, the commercial banks are required to invest 53 per cent of their deposits in government securities or with the Reserve Bank of India. Further, out of the balance, they are required to lend 40 per cent to the priority sector at subsidized interest rates. Likewise, development financial institutions extend loans to certain sectors at a subsidized rate and support rehabilitation packages on concessional terms.

Though well-intentioned in principle, directed credit programmes and interest rate subsidies generally lead to inefficiencies in resource allocation. So, they have to be curtailed over a period of time. This calls for the following

measures:

- * The government must offer market interest rates on its borrowings. (Of course, before doing so, the budgetary deficits have to be brought down so that the burden of public debt is manageable.)
- * The number of priority areas must be limited.
- * The difference between the subsidized rate and market rate must be gradually eliminated.

Improve the foundations of finance

While the Indian financial system may be regarded as reasonably developed, its legal, regulatory, and accounting foundations need to be strengthened. More specifically, steps should be taken to:

- * Enhance the enforceability of financial contracts
- * Provide greater clarity to property rights
- * Facilitate easier transferability of title
- * Tighten prudential control over financial institutions
- * Improve accounting and auditing standards
- * Ensure better flow of information

Broaden public participation in the ownership of financial institutions and banks

Whatever may have been the rationale for state domination of the financial system in the past, it needs to be re-examined now. State ownership of banks and financial institutions has significantly eroded their professional autonomy. Still worse, it has led to the perception that banks and financial institutions are not different from government departments. The inability of the borrowers to distinguish between banks and financial institutions on the one hand and the government on the other has adversely affected the recovery of loans. It has also led to a deterioration in the quality of their loan portfolios. A reduction in government ownership of banks and financial institutions to a level of 51 per cent or so is likely to enhance their professional autonomy, make them more accountable for their performance, sharply separate them from the government in public perception, ameliorate the quality of their loan portfolio, improve their recovery rates, and strengthen these organisations in the long run.

Strengthen and restructure commercial banks and financial institutions

India has a fairly well developed infrastructure of commercial banks and financial institutions. Indeed, the extensive network of commercial banks and the wide array of financial institutions built over the last three to four decades is truly impressive even by international standards. However, in

recent years these institutions, more so the commercial banks, have been impaired by certain wrong policies of the government.

Since commercial banks and development financial institutions are the mainstay of our financial system they should be strengthened. The key measures that may be taken in this respect are:

- * Grant them greater operational autonomy so that they can function as independent entities in a competitive market place.
- * Increase their capital base and clean up their portfolios.
- * Restructure them wherever required by mergers or even split-ups.

Increase the scope for private sector and joint sector institutions

There is a virtual dominance of government-owned institutions in key segments of the financial sector. Insurance companies, commercial banks, term-lending financial institutions, and mutual funds are largely under governmental control. This makes the decisions of these institutions vulnerable to political pressure. Also, it reduces the level of competition and impairs the quality of service. These problems can be mitigated by examining the scope of private sector and joint sector banks, financial intermediaries, and mutual funds.

While widening the scope for private sector and joint sector institutions, the following should be ensured: (a) All institutions of a certain kind, irrespective of whether they belong to the public sector, joint sector or private sector, should be treated alike from tax and other points of view. That is, they should be able to compete on 'level ground'. (b) Proper regulation should be exercised to check malpractices and protect the interest of lenders and customers. (c) Appropriate restrictions may be imposed on the composition of the assets and liabilities of these institutions to ensure their financial soundness.

Nurture the growth of capital market along proper lines

In the realm of capital market regulation, we have a somewhat paradoxical situation. While there is unnecessary and undue restriction over the kinds of securities that can be issued and the pricing of these securities, the regulation that is required over other aspects of the capital markets, seems to be inadequate. This is evident from the following weaknesses in the Indian capital market: insufficient disclosure of information, rampant insider trading, inadequate investor protection, dominant influence of few players, lack of transparency in transactions, and so on.

To nurture the growth of the capital market, the emphasis should shift from product and price control to prudent regulation and supervision. Regulation of the types of securities that can be issued, the pricing of these securities, and the interest and dividend rates payable on them, should be progressively relaxed so that they are determined more by market forces and less by administrative fiat. While product and price controls should be done away with, prudential regulation and supervision must be strengthened to (a) protect the individual investor from fraud, manipulation, and misinformation and (b) maintain free and open markets which are not destabilising to other economic activity.

Widen the range of financing instruments

The range of financing instruments currently available in India is somewhat narrow. For example, a company can issue only one class of equity shares. More important, the choice of debt financing instruments is severely limited. A company can issue either non-convertible debentures (with a maturity period between 5 and 9 years) or convertible debentures.

The limited range of instruments currently available reduces the flexibility to deploy instruments which cater satisfactorily to the needs of investors and the requirements of firms. Investors tend to differ on one or more of the following dimensions: (a) attitude toward various kinds of investment risk (business risk, inflation risk, interest rate risk, and market risk), (b) investment horizon which represents the period for which they would like to invest in a certain security, (c) relative preference for current income and capital appreciation, (d) tax situation in terms of income tax liability and wealth tax burden, and (e) desire to exercise control over the affairs of the firms in which they invest.

Firms requiring finances tend to differ on one or more of the following dimensions: (a) business and financial risk characteristics, (b) period for which funds are required, (c) debt servicing ability over time, (d) willingness to share control with others, and (e) need for tax shelter in the foreseeable future.

If the latitude to devise financing instruments is widened, the scope for servicing the varied needs of investors and satisfying the requirements of companies would improve. In this context, it may be worthwhile to consider the introduction of the following instruments in India: (a) non-voting shares, (b) debentures of widely varying maturities, (c) floating rate debentures, (d) income debentures, (e) debentures with callable and puttable features, and (f) cumulative convertible debentures.

Go for meaningful, but selective privatisation

The government has announced its intention to partially privatise 56 profit-making public sector units by offering 20 per cent equity to mutual funds, financial institutions and others.

While such an action may raise some funds for the government, it is not likely to materially improve the performance of these units because they will be run, for all practical purposes, as other state-owned enterprises.

Instead of partially privatising a large number of public sector undertakings, the government should offer the entire equity in 10-12 profit-making public sector undertakings like HMT, BHEL, and ITI to see how the market responds to such offerings, how the professional management takes roots in such companies, how shareholder democracy works, and how privatisation alters performance. If this is considered too bold and radical, a select number of public sector units may be transformed into joint sector units by involving private sector partners who are willing to pay the highest consideration for their stake of 25 per cent or so.

Gradually forge stronger international linkages

As the Indian financial system becomes more efficient and competitive, the scope for cross-border cash flows and foreign participation may be expanded. Given the growing globalisation of financial markets, its relative isolation will hurt the Indian financial system. Freer international capital movements will bring about a better alignment of domestic and international interest rates. This will increase the availability of overseas capital and widen the opportunities for diversifying risk. Hence, international linkages must be fostered. Of course, such attempts must be gradual and circumspect.

Important pre-conditions

Since the financial system in India has been highly controlled, the liberalization measures suggested above must be carefully phased out over a period of time. The experience of other countries in the world suggests that hasty and premature financial liberalization tends to be destabilising. Hence adequate care must be taken to ensure that financial liberalization is accompanied, or even preceded, by the following: (a) reduction in trade deficit, (b) containment of fiscal deficit, (c) control of inflation, and (d) improvement in legal, regulatory, and accounting foundations. If these pre-conditions are not satisfied or concomitant changes not effected, financial liberalization on per se may not accomplish much.
