The history of indian financial sector economics essay

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Illustrate the history of Indian financial sector, and highlight what were the major changes that took place in liberalization policies of 1991-92 in India's financial sector?

Financial sector of any country depicts the growth and development of the entire economy. It shows the economic prosperity and wealth of the nation and how it matches alongside other countries. " The foundation of credible national security is based on the level of economic prosperity and well-being of the population of any country. This is especially so for developing countries like India. The attainment of sustained high economic growth is a necessary condition for improving the national security and the quality of life of the people throughout the country."[1]

Today Indian economy is developing at a rapid pace of which its financial system forms an indispensible part. India's economy is second only to china in Asia whereas it is among the four fastest developing nations in the world namely Brazil, Russia, China and India (BRIC). It has the largest private equity inflow within Asian Countries. But this was not the case always. The process of transformation has taken its due course and time and the result is what we see today. The liberalization policy adopted by the Government set loose the economy which was waiting to be utilized to the fullest as per its efficiency. Liberalization as per online encyclopedia means ' The process of making policies less constraining of economic activity'. This paper tries to illustrate the transformation in the Indian financial system amidst economic reforms of 1991-1992 and its effect on the system.

HISTORY OF THE INDIAN FINANCIAL MARKET-

Since historic time period India has always been an agrarian country which is mainly because of its geographic conditions and its resources which has been the interests of various people who have tried to take hold of it. The financial sector India dates back with the establishment of British rule in India. The first stock exchange was established in Mumbai in 1875, then in Ahmedabad in 1894, Calcutta 1908 and then in Madras in 1937. Though Britishers looted our country and left us in a miserable state, they established a financial system which had " clearly defined rules governing listing, trading and settlements, a well-developed equity culture if only among the urban rich, a banking system with clear lending norms and recovery procedures, and better corporate laws than most other erstwhile colonies. The 1956 Indian Companies Act, as well as other corporate laws and laws protecting the investors' rights, were built on this foundation."[2]

Though the above mentioned positives stand true the aforementioned negatives share the same spotlight. " A semi organized and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long term financing of the industry, was the state of financial system prior to independence. As a result, the industry had very restricted access to outside savings. It simply means that the financial system was not responsive to opportunities for industrial investment. Such a financial system was clearly incapable of sustaining a high rate of industrial growth, particularly growth of new and innovating enterprises."[3]

After the independence the policy makers adopted for a ' socialist' economy to be practiced in order to drive India to the path of development. ' Socialist'

economy meant that though the private sector will be present but public sector will be the major player in the economy. “ The Indian ¬ nancial system remained a relatively free but unsophisticated market system till the seventies. This included a private banking sector, fragmented but active stock markets, active commodity spot and futures markets. The ¬ rst milestone of India’s socialism was in the 1950s with the closing of the capital account. More changes came in the 1960s and 1970s, with the nationalization of ¬ nancial service providers. This changed the structure of the ¬ nancial services industry from a fairly competitive sector to one dominated by large public sector monopolies. This period also saw the closure of commodity derivatives markets. This took place in the latter part of the 1960s, when these markets saw a large number of trader defaults during a period of three consecutive drought years. At the end of the seventies, the equity market was the only component of Indian ¬ nance that retained a relatively private sector character. Even here, the State is believed to have used UTI, the only mutual fund in the country, to in¬, uence stock prices. Also, while secondary market price discovery was relatively free, the Controller of Capital Issues (CCI) dictated whether, and at what price, ¬ rms could sell shares to the public.”[4]

Due to the presence of stringencies in the system the cross-check or self-adjustment mechanism which could have been provided by global capital markets was absent. The regulatory norms did not provide any room for such measures. There were huge flaws in the financial system at that point of time. “ Most banks were state owned and had negligible equity capital. Basic concepts of accounting, asset classi¬ cation, and provisioning were absent.

The largest of the local stock exchanges, Bombay Stock Exchange (BSE), was a closed market. The exchange focused on the interests of broker members, did not have outreach across the country, and did not have appropriate structures for governance and regulation. Financial transactions were controlled by the RBI (setting interest rates on various products) and the Ministry of Finance (controlling the price at which securities were issued), with a plethora of price and quantity restrictions. The ¬)nancial industry was riddled with entry barriers in every sub-industry. It was extremely di¬ƒcult to start a bank, a mutual fund, a brokerage ¬)rm, an insurance company, a pension fund, a securities exchange or a broking ¬)rm. Apart from banking, foreign ¬)rms could not operate in any of these areas. A comprehensive system of capital controls was in place, which ensured that domestic households and domestic ¬)rms had to go to the domestic ¬)nancial system, in order to access ¬)nancial services. Few areas of the Indian economy were as dominated by the State as was ¬)nance."[5]Trying to raise capital through the means of financial market was not at all feasible due to the complexities involved.

Apart from the financial sector other sector seemed to be equally constrained due to the economic policies. The public sector grew very large and the irony was that it couldn't generate enough income to meet the requirements of the country as a result we had large borrowings. By the time the people in the power came to know about the implication of their decisions, it was too late. The deficits were huge, the public sector industries were turning out to be unprofitable and at a point of time the foreign reserves of the country were so less that it could only have supported

countries needs for near about 2 more weeks. In this case the ‘ lender of the last resort’, World bank and IMF were approached which granted 7 billion dollars as a loan but on the terms that India would reforms its stringent economic policies and liberalize its economy.

The much needed and awaited reform-

The new economic policy was adopted which focused on three main aspects: liberalization, privatization and globalization. From being a more socialist than capitalists it tilted to being majorly capitalists and less socialists. There was a complete drift in economic policies i. e. basis on which the economic policies were earlier drafted were no longer in existence and liberal policies were adopted. This also brought about a sea change in the financial system of the country. Narsimhan committee was also established which looked at the major areas in the financial sector which needed reforms such as; reduction in statutory liquidity ratio and cash reserve ratio (they were astoundingly high which was also one of the major reasons that few commercial banks were in existence), the determination of interests rate should be according to the market forces, the public sector banks should have autonomy.

Due to ease of operation more private players entered the market. There was no more ‘ license raj’ which acted as a stimulus for foreign direct investment. More and more commercial banks and asset management institutions started emerging and also utilized the opportunity to raise debt with the backing of insurance sector. And due to stiff competition in the market there was check and balance mechanism prevailing with relation to

the interests rates. “ In addition, foreign institutional investors (FIIs) were allowed, beginning in 1992; and Indian firms were allowed to issue global depository rights (GDRs) offshore. These additional resources provided finance for India’s private sector-led growth in the mid-1990s, and contributed to a stock market boom.”[6]

MRTP act was abolished which increased the net quantity of imports and exports. “ Reforms in the stock market were accelerated by a stock market scam in 1992 that revealed serious weaknesses in the regulatory mechanism. Reforms implemented include establishment of a statutory regulator; promulgation of rules and regulations governing various types of participants in the capital market and also activities like insider trading and takeover bids; introduction of electronic trading to improve transparency in establishing prices; and dematerialization of shares to eliminate the need for physical movement and storage of paper securities. Effective regulation of stock markets requires the development of institutional expertise, which necessarily requires time, but a good start has been made and India’s stock market is much better regulated today than in the past. This is to some extent reflected in the fact that foreign institutional investors have invested a cumulative $21 billion in Indian stocks since 1993, when this avenue for investment was opened.”[7]

To keep a check on the functioning of the stock market and also due to the scam of 1992, in 1992 SEBI (securities exchange board of India) was established. Though it was established in 1988 but in 1992 it became a separate body. Establishment of SEBI had put a check on illicit activities such as insider trading etc. and also provided a sense of security among investors.

It provided a uniform code of discipline to be followed by the exchanges. It was a major transformation that took place because of the reform. SEBI also abolished ‘ badla’ system which was unique to Indian stock market which was a way of settlement among traders.

The establishment of SEBI was not welcomed by BSE (Bombay stock exchange) which was a sort of monopoly, went against the policy changes introduced by SEBI. Owning to such monopoly led to the creation of NSE (national stock exchange) which eliminated to basic flaws of BSE i. e. there would be no restrictions on new entrants in the equity market and there shall be transparency in the working of the exchange.

1. “ National platform that o¬€ered equal access to traders from all corners of a widespread geographical area,

2. A competitive market in securities intermediation, with a steady pace of entry and exit,

3. Orders matched electronically, on the basis of price-time priority,

4. Anonymous trading followed by guaranteed settlement,

5. Demutualized governance structure, as opposed of being an association of brokers, with a professional management team running the operations of the exchange.”[8]

The success of NSE was evident from the fact that the trading volume increased tremendously and BSE mended its trading ways as per the norms.

" The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign players. The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs. 70, 000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular."[9]Prior to this UTI was the sole player in the mutual fund market.

Insurance sector also transformed accordingly. Similar to the banking sector, insurance had mainly public establishment such as LIC and GIC. Due to liberalization there no. of private companies competing in the market which has provided option to the consumers but the industry still suffers from discrepancies such as " great deal of sale of " insurance" products is merely tax arbitrage, where a fund management product is given preferential tax treatment under the garb of a minimal insurance character."[10]Even the establishment of IRDA (insurance regulatory and development authority) has been inefficient with relation to such flaws.

Conclusion-

With the arguments mentioned above, it can be suitably drawn that Indian Financial system has been refurbished by the 1991-1992 reforms. The practices prior to 1991 were archaic and required modifications as per the

need of the growing countries economy. In my view even if the crisis of 1991 didn't happen the changes that took place should have been incorporated in the system so as to compete with other economies which is evident from the current status of the Indian economy.