2018, WEA On Line Conference

The 2008 Economic Crisis Ten Years On

in Retrospect, Context and Prospect

Discussion Forum: from October 15th to November 30th, 2018

Impact of Financialization: View from India

Dr Pushpangadan Mangari

Abstract

The 2007-08 crisis happened in spite of the theoretical knowledge and understanding of events that could potentially lead to such a crisis. Financialization, the trend arguably behind the crisis, has been prevalent in the advanced economies since the 1970s. Many policies, activities and players related to financialization have led to the crisis. These include accommodating monetary policies by various governments, looser lending norms practiced by international banks, shifts in corporate financing, excessive borrowings by virtually all segments of society, debt fuelled consumption, financial engineering, investments in complex financial market products, regulatory lapses, etc., and they all have contributed to the crisis in varying degrees.

India was unaffected in the 1929 crisis as it was a colony then, relatively unconnected to the world. But not so in 2007-08 crisis, by when it was a part of the globalized world. Like the financialization story, the post-independence Indian economic growth story can be categorised broadly into two phases, one prior to 1980, and the one after. In the early decades, India's financial structure was dominated by debt, and government controlled most of the corporate equity capital. The price at which new public equity offers could be made by private firms had to be approved by the government. Blue chip companies therefore preferred raising debt rather than diluting their equity stake at prices below their intrinsic value. Commercial Banks, which had an upper hand in the Indian financial system, were not allowed to take equity stake in private companies. The largest 14 Indian banks were nationalised in 1969, and as a consequence, remaining banks decided not to grow big, for fear of nationalization. A combination of all these factors led to a slower growth of private corporate sector in India and allowed the state to have a commanding role in the economy and its resource allocation process.

India's major set of financial reforms introduced in 1991, were triggered by a Balance of Payments (BOP) crisis in the early 1990s. These set of reforms, widely seen as a combination of liberalization, globalization and privatization, are also perceived as a shift away from import substitution to export promotion. The financial reforms created a whole new set of financial institutions in the private sector in India.

Going forward, India has few lessons to learn from the crisis and from the emerging, acceptable models of financialization. The article tries to capture some of these.

Author(s) Affiliation and Email

Managing Director, Consultwin Solutions, India

pushpangadan@hotmail.com

Impact of Financialization: View from India

Dr. Pushpangadan Mangari

Unlinked Economy, Unborn theories

Unlike the 2008 crisis which affected virtually all economies in the world, the 1929 crisis did not have a serious impact in the economies considered peripheral then, including India. In terms of output, there was reportedly no depression in India during the period between 1929 and 1934. Exports and imports did get affected adversely, as overall world demand generally fell. However, in India's case, it was almost entirely compensated by increased domestic agricultural and industrial production during the same period. India was relatively unconnected and therefore insulated in the world then and externalities were not impacting its economy either way.

No known theoretical frameworks were in place in the pre-World War II era, even in more developed countries, to understand or determine how economies suffered from external events or from sustained lack of global demand for their products. Arguably, much of the theoretical insights in this area came later with the General Theory of Keynes (1936) that explained as to how some of these events do happen, as also how these could possibly be prevented from recurring. There is now a high degree of global consensus on the Keynesian view of business cycles and the likely impact of counter cyclical fiscal policies that could be adopted by national governments, during adverse times. However, in spite of this theoretical knowledge, neither economists nor national governments could predict or prevent 2008 crisis from happening.

Global Financialization

Financialization is generally seen as emanating from the rise of financial power and its larger role in businesses. As per Gerald Epstein, financialization is "the increasing role of financial motives, financial markets, financial actors and financial institutions in domestic and international economy". As a quantitative phenomenon, financialization is measured as an increase in the share of output and income generated in the financial sector, higher prices for financial assets, and a greater volume of business activities in financial markets and institutions, as compared to the real sector. Its linkages to the "real" economy of business, governments and households are however, increasingly being questioned.

Private finance, especially global finance played a much smaller role during 1945 to 1980. This was partly due to the crisis of 1930s, as it took time to recover from the shock. Post 1980, things changed dramatically with financial and non-financial capital behaving as two clear cut entities with distinct, and in some cases, conflicting interests. In the decades prior to 1980s, most of the corporate profits remained within the firm, and major part of new investments was financed by retained profits. But for the last few decades, larger shares of the firm's profits have been distributed to shareholders. This trend demonstrates that either there are fewer opportunities for non-financial investment, or that financial claims are more exigent. The most convincing explanation for this trend is the growing realisation that shareholders are in general, more desirous of or more capable of demanding, higher pay outs. Obviously, the shareholders and managers of these firms do behave as distinct groups and shareholders do not regard funds in corporate treasuries as equivalent to their personal wealth. This is a major change in corporate stake holders' outlook.

The key drivers of financialization in the advanced economies since the 1970s were the shifts in favour of market-determined economic policies, financial market deregulations, and capital

account liberalizations. The 1980s were seen coinciding with the neoliberal era and globalization. The British government removed capital controls and let the currency float freely in 1979 and the Nordic countries liberalized by the 1980s. Other European countries adopted a slower, gradual approach, but by 1990 capital controls were abolished in principle as part of the first stage of European Monetary Union. Capital controls in the European region gave way to the single market, and the single market encouraged the process of competitive deregulation of domestic financial sector.

Financialization in India

Before the Industrial Revolution in the late 18th century, GDP per capita was similar in most of the world, and the two biggest economies then were China and India simply because they had the largest populations (Maddison 2001). In the 19th and 20th centuries, two major forces impacted the world economy. The first was Industrial Revolution, with its advancements in manufacturing, production technology, electrification, private property rights, improved education, etc., that enabled few countries to take off faster economically. The second force was a growth retarding one, namely colonization. It had a negative impact on the economies of most of the colonised world until around 1960. India, which got independence from the British Rule in 1947, was a victim of the second force.

The post-independence Indian economic growth story can be categorised broadly into two phases: One prior to 1980, and the one after. Before 1980, post-independence, India's average GDP growth was 3.5% per annum. From early 1980s onwards, India achieved stronger GDP growth rates, averaging 5.9% per annum for the period 1980 to 2000, 8.8% per annum from 2000 to 2010 and 7.1% from 2011 onwards. As per Purchasing Power Parity (PPP) based GDP, India came at 4th place globally, with output of $3 trillion, way back in 2001. Currently India is the 3rd largest economy in PPP terms with a per capita GDP of USD 7,783 as of 2018.

The financial structure in India was and continues to be strongly bank-based, though things have changed a lot in terms of reforms and regulations. During the early decades after independence in 1947, the fixed interest funds dominated the financial market, instead of equity capital. This pattern was mainly due to the fact that the government controlled most (about 60%) of the Indian corporate equity capital, and no fresh equity offers were being made to private sector for a considerable period of time. The price at which new public equity offers could be made by private firms had to be approved by the government, which discouraged new equity issuance by well performing private companies. Blue chip companies preferred raising debt rather than diluting their equity stake at prices considered way below their intrinsic value. Commercial Banks, which had an upper hand in the Indian financial system, were also not allowed to take equity stake in private companies. On top of it, the largest 14 Indian banks were nationalised in 1969, and as a consequence, remaining banks possibly decided not to grow big, for fear of nationalization. A combination of all these factors led to a slower growth of corporate sector in India.

Like many other countries, Government of India was, and continues to be, a major borrower in the Indian economy. Government typically places the debt with the Reserve Bank of India, the central bank, which then sells them down using primary dealers as market makers. In the early decades, restrictions were put on capital mobility by way of regulatory requirements for banks to hold substantial amount of public debt. These restrictions do continue, albeit in diluted form. The easy, captive sources of additional capital made the financial discipline at sovereign level a non-serious subject. The Reserve Bank of India also did not enjoy a degree of independence comparable to that of say, an ECB, or the Fed. In a way, India demonstrated a felt need for

financialization, in the sense that some of the fair market, desirable policies were critically required by it. But in spite of having a more or less a nationwide acceptance and support for the policies, they were not accepted due to political reasons.

The evolution of the financial regulatory system in independent India can be broadly categorized into three separate periods. The first was a relatively unregulated period, between 1947 and 1969, sometimes called the pre-nationalization era. This was followed by a period of increased direct intervention between 1969 and 1991, or the era of "social control". The nationalization of 14 banks in 1969 was part of this intervention, and an attempt to reset social priorities. With the nationalization of large banks, more than 80% of the deposits in the Indian economy indirectly came under government control. The government also had direct control over the interest rates and the distribution of credit. The third and ongoing phase is a less regulated, more privatized, market oriented financial system, which began in 1991, called the era of financial reforms.

In the early decades post-independence, Indian economy was seen as a closed one with focus on import substitution and export pessimism, both aimed at self-reliance. Like other major oil importing countries, Indian economy also suffered seriously by the oil price shocks of 1970s. The 1980s were better in terms of economic growth for India, but it had to begin the decade of 1990s with a major Balance of Payments (BOP) crisis. This triggered a set of economic reforms, which are widely seen as a combination of liberalization, globalization and privatization. Strategy wise, it is perceived as a paradigm shift, as the nation moved away from import substitution to export promotion. The initial focus of the reforms was on freeing the market, and recreating and reorganising it in a manner that was open to competition, leaving space for creativity and development of new products and markets. Even though the reform process was gradualist in nature, India now has a more or less open market, with very few areas like infrastructure, banking, health, etc., still needing more reforms.

A key element of these economic reforms was the restructuring of the financial sector with a more market oriented approach, aimed at liberalizing the banks from central controls and enabling them to compete in a liberalized and globalized environment, on commercial basis. While currently there is increased private sector competition in the banking segment, public sector banks continue to dominate Indian financial intermediation, allowing room for direct and indirect control by the government. The exchange rate regime remains one of managed float, and there are significant restrictions on capital flows. These controls admittedly do limit the volatility impact of international financial markets. The Indian Government, however, wants to attract foreign capital, both debt and equity, and has liberalised the Foreign Direct Investment (FDI) limits in most segments.

The 1991 reforms were badly required as India, after four decades of centralized planning, realised that the government had reached commanding heights of the economy, with virtual monopoly in many business segments like heavy capital goods, minerals and formal finance. Along with the licensing system, government had huge control over allocation of resources and significant influence over the entire economy. Post reforms, the national capitalism during centralized planning era gave way to global capitalism. A New Economic Policy of 1991 (NEP) was born. Banking and finance continue to be regulated and credit by and large, arguably is still indirectly under the state control.

The financial reforms created a whole new set of financial institutions in the private sector in India. They included private sector mutual funds, new generation banks, life and non-life

insurance companies, term lending institutions, infrastructure companies, and non-banking finance companies (NBFCs). Post-nationalization in 1969, the public sector bank network had an exponential growth. The financial sector also saw technology enabled financial products and services like ATMs, Debit / Credit Cards, Mobile banking, Net banking, etc. Over all, the financial sector looked more vibrant. Increasingly, foreign direct investments and portfolio investments found their way into Indian markets and firms.

Financial liberalization meant moving away from directed lending as a policy lever, particularly to the agricultural sector and to small scale industry. This had serious distributional consequences for the Indian poor, mainly in the rural belt. Financial inclusion was therefore explicitly readopted as a stated goal of the Reserve Bank of India in the mid-2000s, and RBI began to promote financial inclusion. It recommended that all national banks promote financial inclusion as a prime objective in their business plans. The focus however, moved away from directed lending to providing newer products such as no-frills accounts, simplifying registration norms, providing credit thorough Kisan Credit Cards (Farmer credit cards) and the like. The current government has expanded the menu by restarting direct lending through schemes like the *Mudra Loans* to identified small and medium entrepreneurs.

Mutual funds and investment vehicles that take part in equity markets grew considerably in the post liberal era. There are 43 mutual funds in India currently. They collectively manage, under their 2600 odd schemes, an asset size (Assets under Management or AUM) of over USD 350 billion. There are 57 insurance companies in India today, of which 24 are life insurance firms. The insurance industry is expected to reach USD 280 billion by 2020.

Stock markets have been performing exceedingly well in India, post-reforms. The Bombay Stock Exchange Sensitive Index (Sensex) multiplied more than 12 times in the last 15 years [On May 6, 2003, the Sensex was at 3,001, as compared to 38,390 on 7th September 2018).

Few Policies Leading to Crisis

During 2000 to 2008, the world witnessed a huge credit boom in its history. This boom created opportunities for cheap financing in both developed and emerging economies. The first phase of global liquidity that started in 2003, lasted till 2008. Global banking network was its key driver, which generated massive capital flows in the sector with looser financial terms and conditions across the national borders. Given the overall liquidity, global banks could leverage their balance sheets easily, and that helped the process. The European banks spearheaded financialization particularly from 1999 and they played a pivotal role in creation of high levels of global liquidity, using their US branches. The dollar-denominated funding they collected from the US money markets were mostly invested in securities created by the US shadow banking system.

While banks were leveraging beyond normal limits, the financial regulators in major economies, particularly in the developed countries either neglected or chose to ignore the development. The banks certainly had huge incentives to take higher risks, and they did take them. The financial segment regulators, however, could not or did not notice the critical information on bank leverage. The micro models that got developed as part of the process, were too complex and not easily amenable to predictions. Most market players were simply happy with the developments and believed that the markets were very efficient. In any case, the system was considered too big to fail for each large economy and it was also probably perceived to be the concerned central banker's responsibility to bail them out, should a crisis materialise.

Encouraging consumption has always been a constant theme of nations. Inflation of 1970s, public debts in 1980s, private debt of 1980s and QE of 2000s were all aimed at increasing consumption. The rise in unsustainable, debt fuelled household consumption did not attract much attention. On the other hand, experts from many quarters observed that the rise in household debt was linked to the increasingly unequal distribution of household income. This line of argument, in a way legitimised the excess leverage, as a logical redistribution model enabled by the emerging financial system. An alternative view that emerged saw lower-income households borrowing more to sustain rising living standards in the face of stagnating incomes. A differing voice was from Rajan, who cautioned that efforts to encourage lending to poorer households left the intended beneficiaries with unmanageable debt.

Another quantitative increase in the size of finance in the US, where the crisis took birth, was in the area of education. Expenditure on higher education in any economy, is typically seen as one funded directly by government, using tax payer's money. This model got changed to a model of financing through individual debt claims, mainly in the US. These assets were then packaged and traded as a separate class of assets. Student debt is currently a highly visible social financial asset class in the US. An important outcome of this re-designing of social responsibilities is the re-prioritization and re-working of household expenses and budgets. This asset class added to the problem of ballooning household debt.

Governments are always known for indiscipline, in most part of the world. A disciplined government would live within its means and would not require any funding from external sources. Such an economy would not have deficits. But most countries are not so disciplined and their financing of large deficits and "mispricing" of sovereign bonds played a major part in creation of the financial crisis.

Considering all aspects, it would be fair to say that the accommodating monetary policies by various governments over the period 2002–2005, looser lending norms practiced by international banks, excessive borrowings by virtually all segments of society, unsustainable debt levels for consumption, investments in complex financial market products, shift in designs of basic social responsibilities by governments, regulatory lapses, etc., were all among the factors behind the huge run-up in asset prices and financial imbalances, prior to 2007. A partial unwinding of these imbalances triggered the 2007-08 financial market crisis and the panic created thereafter made it a man-made, global calamity.

Other Crisis Drivers

Some of the other drivers for the crisis, more relevant for an emerging market like Indian economy, were as under:

a. Engineered Growth, Endangered Growth

Financial reengineering has now become all pervasive. It has many forms. In debt markets, it multiplies investments without creation of any real assets or wealth. A decline in yields increase the asset values without any action on the part of investors. This phenomenon has resulted in both higher volumes of issuance of bonds and acceptance of riskier bonds by yield hungry investors.

This growth of finance as an industry went up significantly in every sphere. The debt to GDP ratio itself went up everywhere. In the US, household debt to GDP went upto 100% in 2007, from 66% a decade ago. UK household debt was at 109% of GDP by 2008. Household financial assets rose from 250 percent of GDP in 1980 to 400 percent in the

mid-2000s. The value of nonfinancial household assets – overwhelmingly houses – also increased as a share of GDP in the mid-2000s.

Low yields prompted investors to go for risky, high yield instruments elsewhere, like securitized assets. Just 10% of mortgages in US were securitized in 1990 and this percentage went upto 70% by 2007. The higher issuance of debt encouraged higher leverages by all – governments, banks, firms and individuals. Even debt of individuals with doubtful credit quality were repackaged and traded. Same situation prevailed in the equity market as well. The year 2007 was a record year for fund raising for the global private equity industry.

Another development was the change in business strategies of firms. Corporates increasingly started using financial products to improve their bottom line. Corporate treasuries, which used to be mainly back offices in the not so distant past, repositioned themselves as profit centres in many firms. Investing and trading in securities including speculative assets, became an active part of such treasuries. The *other income* of corporates has now become critical in most firms. These incomes include profit from portfolio or strategic investments, trading in securities and commodities, profits from FX transactions, profit from real estate assets, etc. In the case of commercial banks and funding institutions, fee based income have become a significant component of firm's overall income. Financial sector profits almost reached half of corporate profits by 2007 in the US. Some larger firms even extend the concept of portfolio to subsidiary businesses. For them, acquiring and selling stand-alone business units is a profit generating, active business in itself.

A more recent development is the consolidation of financial claims into few large, centrally managed funds. Reports suggest that the probability that two randomly selected firms in the same industry from the S&P 1500 have a common shareholder with at least 5% stakes in both firms increased from less than 20% in 1999 to 90% in 2014. When ownership interests are pooled in such large funds, the organizational goals can get blurred. For example, a fund's objective can be at variance with the firm's, especially when it has also invested in say, in a competitor firm. Finance, in such cases can discourage competition. This is obviously a concern for those who see market competition as promoting socially desirable outcomes.

Complex, structured financial products mushroomed in the first decade of this century. These instruments were designed in a manner that did not help investors understand it properly in terms of its real intrinsic value or identify its ultimate bearer of risks, in case of a potential credit default. Many of these instruments turned 'toxic' after the collapse of credit.

b. Unstable Macro-economic Rectangle

The centre of gravity of the global financial activities, according to many experts, lie in the so called, much publicized, macro-economic rectangle. On Side A, the rectangle had the consuming nations of the west, on side B, the workshop of (emerging) nations, on Side C, the nations that provide natural resource (hydrocarbon, commodities, minerals etc.) and on Side D, the capital goods providers (Japan and Germany) for the developing nations. The nations in sides B, C and D category typically had surplus savings, and the same has been mostly invested in US $ denominated assets, mainly in US bonds.

These nations arguably played their expected part and delivered in the decade prior to the 2007 Crisis. But the rectangle was inherently unstable and is now being blamed for the crisis. The low saving, high consumption model of Side A, was certainly unsustainable. The credit fuelled asset bubble of west had to finally burst. The commodity super cycle from 2000 to 2008, while helping Side C economies, did create imbalances in major commodity consuming nations. The concept now needs a hard relook.

c. Shift in Corporate Finance

For decades, the funding frame work for large corporates and mid-size corporates, including the ones in India, were structurally different. Large companies typically had high, investment grade credit rating, and they could mobilize debt finance from many sources easily. For mid-size corporates which did not enjoy such high ratings, the access to debt was historically from a small group of banks. The amortising nature of these middle size term loans reduced the refinancing risk that companies faced at maturity of debt. But non-bank lenders typically did not prefer amortisation of debt, as it reduced their income bearing assets. Instead, they preferred bullet repayment structures. This in turn, allowed mid-size corporates to reinvest higher percentage of their operating cash flows into their own businesses, for growth.

Necessity is the mother of inventions and private equity investors came at this juncture to mid-sized companies with innovative financing ideas. These ideas included a variety of options like longer maturities, amortising and non-amortising tranches, and ever evolving covenant structures. These firms, over a period of time, became a critical source of funding for the mid-size market. Many non-bank lenders had greater risk appetites than banks, and often ended up lending to a higher level, as compared to banks. They also serviced the client needs far more flexibly and quickly as they generally had lower regulatory restrictions. In addition, non-bank lenders did not seek ancillary revenues for transactional services, which are essential profit streams for banks. All in all, it was win-win for both lenders and borrowers. Major pain points were the private equity investors' infamous, merciless stripping of investee firm assets and their scant respect for other stake holders' interests, when it came to returns on investment.

The non-bank lending has been on rise world over. Since 1980, the financial sector has doubled its weight in the US economy, but the bank lending there fell from 75% of the market in the 1950s to less than a third in the early 2000s. The remainder was undertaken by non-bank lenders and capital markets. Growth of non-bank lending is welcome, but generally their cost of funding is higher, as many among them raise their funds from banks themselves.

Post Crisis Era

Unlike the 1930s, governments were quick to act in 2007-08 crisis. The G20 countries decided to "use fiscal measures to stimulate domestic demand to rapid effect". The 'Quantitative Easing' (QE) that followed, is a logical extension of normal central bank action, when the interest rates are near zero. In a typical economy, the overnight rate is linked to all other interest rates on the yield curve, and in turn all other financial asset prices are linked to interest rates. Through overnight rates, the central bank can signal its intentions to set future interest rates. But central banks cannot use interest rates as effective tools when the rates are close to Zero. Instead, they expand the size of their balance sheets by purchasing assets or increasing their lending, thereby pump-priming the economies. Many consider QE an artificial respiration that

works. Effectively the economies that launched QE, took the risk of a future inflation, as compared to risk of immediate deflation.

There is an anti-inflationary interpretation to the QE phenomenon. The argument is as follows. The monetary easing effect comes from a process called "portfolio rebalance effect". This process happens when a central bank acquires a large amount of securities or other assets, as it then alters the relative supply of assets in private sector portfolios, exchanging the assets it purchases for another set of liquid assets, the central bank reserves. This has a cascading effect in the sense that the individual portfolio holders, with the altered portfolios will also rebalance their portfolios, and that process will have an impact on asset prices. That may not, however, add to inflation as the excess reserves created by QE are the balance sheet counterpart to the assets the central bank takes out of the system. Individual banks cannot and do not use reserves to directly lend to non-bank borrowers. They can use their reserves to lend to other banks or use them to buy assets or create a new loan, thus creating a new deposit, and use up the reserves when the borrower withdraws the money.

As a result of QE, the second phase of global liquidity led credit boom started around 2010 and it targetted the international bond market, especially the international bond market in emerging economies as its preferred market. The aim was to get maximum yield. However, with the explosion of debt issues in the global debt securities, there was a decline in risk premium for debt securities across the markets, in line with the developed economies. But offshore issuance of corporate bonds in foreign currency resulted in currency mismatches in the consolidated balance sheets of emerging market firms.

In many countries like UK, debt increased following the Crisis, led by a collapse of aggregate demand globally. Some governments, in the post 2008 situation, were forced to reduce their budget deficits through fiscal austerity. And the fiscal tightening did have a negative impact on their economic activities. When the Euro crisis hit in 2010, the global reaction was to tighten fiscal policy, in the entire Eurozone, in the US and the UK. Arguably, this would have damaged the recovery, and some economists do feel that the Eurozone as a whole would have lost about 10% of its GDP due to this forced, fiscal austerity. From 2010 to 2013 there was a substantial fiscal contraction in the Eurozone as a whole, alongside similar movements in the US and UK. The second Eurozone recession was, according to some experts, induced by this demand contraction.

The slowdown in 2010 spread from US and Europe to emerging economies as well. Deutsche Bank and Morgan Stanley named Brazil, India, Indonesia, Turkey, and South Africa the Fragile Five, because they suffered particularly large currency outflows in May and June 2013 and their floating exchange rates plummeted. Their common characteristics were that they received excessive volumes of short-term international financial inflows, which encouraged them to accept excessive current account deficits for longer periods. Among the five, India and South Africa had substantial budget deficits, and Brazil and India had public debt in excess of two-thirds of GDP, a dangerous level for emerging economies in bad times.

During the post 2008 crisis era, only nine countries reportedly grew at 7 percent or above (Ruchir Sharma, 2016), whereas this number was over 60 in 2007. India was the largest economy among these 9 countries, suggesting that India managed to grow in spite of external pressures. On a global basis, many believe that the world would now grow about a percentage lower than the average of 3 percent that it grew over the last 3 decades.

Criticality of Financialization

The wealth models have changed over the decades, across globe. Financialization does bring in few critical benefits. But its various dimensions have to be analysed and managed properly. The conflict between financialization and policy autonomy for instance, can limit the extent to which financialization proceeds. These conflicts have to be managed, in line with the economic and social objectives. Similarly, most of the variation in net wealth, both over time and across countries, is driven by valuation changes in existing assets, including land, now, rather than investment spending. This area is critical as it is here that the asset bubbles get created.

Financing depends on factors other than the prevailing interest rates. The idea that persistent low rates contribute to asset bubbles and other forms of financial fragility is a reasonable argument for tightening. Therefore the notion of a "global savings glut" as the source of macroeconomic instability, as proposed by Bernanke, has to be seen in right context. An important factor to be monitored is the liquidity cycle, which continues to be globally linked and controlled by the central banks, led by US Fed.

Lessons for India: Right Type and level of Financialization

Is there a right type and level of financialization for a given country? Financial liberalization, as a policy, must aim to discipline public and private actors in limiting their choices to ensure socially desirable outcomes, without hurting entrepreneurship and sustainability of businesses. There has to be a balance in terms of claims on corporate earnings from various stake holders like its notional "owners", other stake holders like workers, government, etc. The growth aspirations and survival goals of management must also be reckoned. Some of the immediate lessons relating to financialization that India could learn from western economies include a steady, phased approach to financial liberalization, inculcating a habit of moderate borrowings for consumption and business growth, taking care of the real economy and encouraging investment in productivity. Creating, dealing and managing speculative assets cannot possibly be a top of the table priority for a developing country like India.

India did learn a hard lesson in the mid-1990s. When the clamour for universal banking was at its peak then, some major development banks like ICICI become wholesale banks. The outcome, however, proved to be problematic for the growth of long-term finance in India as the public sector banks got overburdened with financing the whole economy. It is still unclear as to whether the development banks that got converted into commercial banks achieved their objectives. One of the converted development banks, IDBI, is currently being taken over by the Indian insurance giant, Life Insurance Corporation of India (LIC), as it has turned sick and become unviable.

When the finance sector gets too large related to the size of an economy, the economic growth decelerates or declines. It pulls talent from productive to unproductive sectors like say, speculative businesses. Most of speculative businesses are part of financialization. This needs to be corrected by use of a judicious mix of strong deterrents and incentives. Direct government intervention in financial markets would be required to contain the unwanted, higher levels of speculation, while allowing space for liquidity creation.

The stock markets were expected to fill the gap left by long-term financial institutions. However, they are still found wanting when it comes to raising new capital, especially for small and medium sized firms. Regular trading takes place in fewer stocks. And most of the volume is for speculative purposes. *Casino capitalism*, made popular by Susan Strange, is highly visible in Indian capital markets. The '*badla*' system that prevailed in most of the Indian stock

exchanges earlier (other than in the National Stock Exchange and OTC Exchange of India), were known for non-delivery based, highly speculative trading. This practice has since been stopped.

A closer look at the data from India's central bank (the Reserve Bank of India or RBI) indicates that there has been a steady rise in financial securities as a proportion of total assets held by Indian corporates in the decade ending in 2011-12, along with a proportionate declines in shares held relating to industrial securities. Industrial securities dropped from 40 percent in 2002–2003 to 15 percent by 2011-12. During the same period, the proportion of financial securities as a share of the assets held by corporates rose from less than 60 percent to over 70 percent. This observation confirms the excessive financialization of Indian corporates, threatening the industrial productive capacity of the economy.

The tendency of corporates using financialization models and preferring short-term financial assets as opposed to long-term physical investments is a critical issue. A case in point is the infrastructure segment where long term, high value physical assets were developed, using the Private Public Partnerships (PPP) successfully in the earlier decades. The search for quick returns in high-risk, short-term assets is prompting private players to go slow on these projects. In the final analysis, it is observed that there has been a lower growth in corporates' gross physical assets. Possibility of stagnation in the real economy is staring at us and if the trend continues, it would be reality soon. In order to arrest these trends, productivity in real economy has to be encouraged.

Another area of concern is the trend of corporates to borrow heavily from capital markets, both from within and outside the country. This is partly attributable to the fact that the Indian primary market is not deep enough. The corporate tendency to rely on the financial sector, using borrowed capital to meet other liabilities, can generate a Minskyan Ponzi finance (Minsky 2008) type of situation. The problem of external borrowings also bring in additional risks in terms of foreign currency volatility and hedging related issues. Over enthusiastic large corporates or a group of corporates can create imbalances in an economy with their excessive faith in financialization of business activities, unmindful of likely risks.

An important area where the financialization can play a critical role in India is in reverse mortgage. Though the Union Budget 2007-2008 introduced this proposal, it is yet to take off. If implemented properly, senior citizens who hold properties, but lack a regular source of income can get a regular income from the arrangement, while continuing to stay in the property. In a country that does not have basic welfare schemes and plans, this would be a welcome one.

Another area where financialization can and must intervene is the Micro, Small and Medium Enterprises (MSME) segment. In the Indian corporate world, the big corporates are becoming bigger, and there is a visible absence of effective competition from the MSME. That implies that new entrepreneurs are unable to challenge existing players with innovative technologies and processes. Financialization is apparently not helping MSME to climb up the ladder fast and strong enough. This needs to change. Financialization can and must be a game changer here.

*****

References:

1. **Ghemawat, Pankaj:** World 3.0 (2011)

2. **GHI Workshop (Feb 5-6, 2010:** Cultures of Credit: Consumer Lending and Borrowing in Modern Economics.
3. **Green, Stephen:** Good Value (2009)
4. **Investment Management Journal**, Morgan Stanley, various issues.
5. **Kelkar, Vikay L.** "India: On the Growth Turnpike" (2004 Narayanan Oration, ANU, Canberra).
6. **Kotz, David M**: Neoliberalism and Financialization (2008)
7. **Lee, Kwan Ok, Mori, Masaki & Qian, Wenlan**: Conspicuous Consumption and Household Indebtedness.
8. **Levi Economics Institute of Bard College**: Various Working Papers and publications.
9. **Sen, Sunanda & DasGupta, Zico**: Financialization and Corporate Investment.
10. **Sharma, Ruchir**: The Rise and Fall of Nations (2016)