Institute of Economic Growth

POLICY BRIEF

2 / 2013

FINANCIAL ACCESS IN POST-REFORM INDIA

T A BHAVANI AND N R BHANUMURTHY

In India, systemic reforms of the financial sector have been undertaken toward liberalisation of hitherto quantitative controls as a part of the new economic policy reforms of 1991. It is expected that the reforms improve competitiveness of the financial system over time and expand financial access through enhanced efficiency and cost reductions. Against this background, the state (level and changes) of financial access in post-1991 India is examined from the macroeconomic growth perspective. Specifically, financial access is assessed in terms of availability and adequacy of loans from the formal financial system for productive investment in different sectors/segments of the economy. Empirical analysis reveals that the agriculture sector and the unorganised segment of the Indian economy have limited financial access despite numerous policy measures. The oft-repeated reasons for such limited financial access are high risk and higher transaction costs of providing finance but few existing policies focus on reducing these costs. Some of the policy suggestions that this study makes are to issue PSL certificates that are tradable in the market so as to encourage some of the banks to specialise in lending to agriculture and other unorganised segments; encourage banks to link lending to savings through innovative deposit schemes; and allow local area banks.

CONCEPT AND MEASUREMENT OF FINANCIAL ACCESS

Financial access broadly refers to making financial services such as savings, credit, insurance, and payments accessible to all potential users without any barrier—price or non-price. It depends on the availability of financial services (i.e. physical access), eligibility, and affordability of users.

In the literature, financial access has been approached, in the name of financial inclusion, from the microeconomic angle focusing on individuals/households for welfare reasons. However, we approach the issue of financial access from the macroeconomic growth perspective as this is more sustainable. Given that a significant percentage of not only individuals/households but also production organisations is not covered by the formal financial system in developing countries like India, financial access has important growth implications besides having welfare consequences. Further, economic growth assumes critical significance in the Indian context as a powerful instrument in reducing poverty and improving levels of living. We, therefore, analyse financial access in terms of formal financial system providing financial resources for the productive investment requirements of the growth process in India.

We consider *actual use* of formal financial resources in relation to *need* (actual investment undertaken) as an indicator of financial access as it is difficult to assess potential uses owing to data problems. Further, use of the formal financial system is examined at two levels: one, production organisations obtaining financial resources such as credit from the formal financial system for the purpose of productive investment;

TA Bhavani is at the Institute of Economic Growth (IEG), New Delhi and N R Bhanumurthy is with the National Institute of Public Finance and Policy, New Delhi. This policy brief is based on their 2012 book *Financial Access in Post-Reform India* (New Delhi: Oxford University Press). The book is a revised version of a research study report entitled *Impact of Financial Sector Reform in India: How Has Reform Widened Access to Financial Services and What Lesson Can Policy Makers Learn?* submitted to the British High Commission, New Delhi. The study was undertaken at the IEG. All views and opinions in this policy brief are of the authors only and not necessarily those of the institutions mentioned.

two, adequacy of financial resources from the formal financial sector in taking care of the investment requirements of production organisations. Adequacy of resources obtained from the formal sources of finance is measured in terms of 'financial resource gap' (FRG) defined as [1- (financed availed from financial resources/productive investment undertaken)]. FRG varies between zero and one (100 in percentage terms), which indicates full financial *inclusion* and *exclusion* respectively.

The study measures financial access at different levels of aggregation: economy, segment (organised and unorganised) and sector level (agriculture, industry, and services). We measure financial access for the sectors using secondary data mostly unit level data (NSS and companies data). We arrive at segment and economy level financial access as a weighted average of financial access/FRG of sectors and segments within the sectors weights being their GDP shares.

EMPIRICAL FINDINGS

Agriculture sector, and unorganised service and manufacturing enterprises, revealed limited access to formal financial system in terms of availability and adequacy of loans. Empirical evidence indicates not only limited financial access but also unequal access across enterprises.

Based on the available information, we find that the agriculture sector has the largest financial resource gap (49%) followed by the service sector (41%) because a large segment of these two sectors is unorganised. The industry sector that has a larger organised segment showed the resource gap of only 22% (see Table 1).

At an aggregate economy level, financial resource gap was estimated to be 39%. As expected, financial resource gap was the largest for the unorganised segment of the economy (68%) implying only 32% of its investment requirements were financed by the formal financial system (see Table 1).

Table 1: Financial Resource Gap - 2004-05: Segments and Economy

	Agriculture	*Industry*	*Services*	*Total*
Unorganised Sectoral GDP Share	0.38	0.15	0.47	1.00
Financial Resource Gap	51.61	76.3	91.16	67.53
Organised Sectoral GDP Share	0.03	0.30	0.67	1.00
Financial Resource Gap	0.00	0.00	0.00	0.00
Economy Sectoral GDP Share	0.19	0.21	0.60	1.00
Financial Resource Gap	49.00	22.00	41.00	38.53

Notes: Sectoral GDP shares of the unorganised segment are taken from the National Commission for Enterprises in the Unorganized Sector NCEUS (2007). We have computed sectoral GDP shares of the organised segment using NCEUS (2007)' estimated GDP shares of the organised segment in different sectors. Financial resource gap is computed based on NSS unit level data for the unorganised segment of the industry and service sectors and on RBI data for the agriculture.

India stands last among the four selected countries, that is, the UK, Brazil, and China in terms of aggregate scores and ranks in respect of financial sector liberalisation, bank financial services, non-bank financial services, and financial access (Table 2). The only exception is financial markets in which India stands next to the UK although its private bond market is yet to be developed.

Table 2: Status of Financial Sector Liberalisation, Development, and Access: International Comparison of India

Indicators	India		Brazil		China		UK	
	Rank[1]	Score[2]	Rank	Score	Rank	Score	Rank	Score
Financial sector liberalisation[3]	51	1.90	30	5.27	43	3.00	1	7.00
Banking financial services[4]	39	3.10	35	3.50	10	4.80	2	5.30
Size index[5]	36	2.30	27	3.10	8	6.0	1	6.0
Efficiency index[6]	32	4.80	47	3.70	30	4.90	24	5.30
Non-banking financial services	17	3.10	15	3.20	12	3.30	1	6.40
Financial market development[7]	22	2.96	37	1.86	26	2.74	2	5.52
Equity market development[8]	27	2.70	39	2.00	13	4.10	4	5.50
Bond market development[9]	27	2.60	30	2.40	29	2.10	14	3.60
Financial access[10]	48	2.80	31	3.30	30	3.30	16	4.00

Source: The Financial Development Report 2009. World Economic Forum, Geneva and World Economic Forum USA Inc., New York, 2009.

Notes:

1. Rank refers to the country's rank out of the 55 countries that are covered in the report.
2. Score is in the scale of 1-7.
3. Domestic financial sector liberalisation index was calculated on the basis of whether or not controls on interest rates and credit exist and whether or not deposits in foreign currency are allowed.
4. Banking financial services score is the weighted average of size index, efficiency index, and financial information disclosure with 40%, 40%, and 20% weight, respectively.
5. Size index is the weighted average of the score for seven parameters such as deposit money bank deposits, private credit, and bank deposits—all normalised by GDP.
6. Efficiency index is the weighted average of five parameters such as aggregate profitability indicator, bank's operating costs to assets, and non-performing loans to total loans.
7. Financial market development is the weighted average of the scores for equity, bond, foreign exchange, and derivatives markets with 30% weight for the first two markets each and 20% weight for the last two markets each.
8. Equity market development is the weighted average of four parameters including stock market capitalisation and stock market value traded—both normalised to GDP.
9. Bond market development is the weighted average of four parameters including private domestic bond market capitalisation and public domestic bond market capitalisation—both normalised to GDP.
10. Financial access is an aggregate of 11 parameters such as market penetration of bank accounts, commercial bank branches, and availability of venture capital.

POLICY SUGGESTIONS

Empirical analysis of the study clearly indicates that the unorganised segment covering agriculture, micro, and small enterprises (in industry as well as services sectors) has limited financial access with a wider financial resource gap. The often cited reasons for the limited financial access of the unorganised segment are high risk and high transaction costs.

Majority of the existing policies hardly focus on reducing risk and transaction costs. The policies that are in operation in respect of lending to agriculture, micro and small enterprises are priority sector lending (PSL), credit guarantee schemes (CGS), refinance schemes, interest/ capital subsidy programmes, and other schemes of state and central government such as Swarna Jayanti Grameen Swarojgar Yojana (SGSY). Only CGS reduces lenders' risk by government absorbing risk, and thus encourages credit flow to the specified segment. Government, however, cannot absorb risk and cost forever given ever increasing demands on its limited resources. Policy measures that do not reduce risk and transaction costs are not sustainable. For these reasons, despite numerous policy measures, financial access remained limited in India. At the same time, policy measures like PSL not only restrict risk diversification by banks but also not encourage banks to specialise in lending to the specified sectors. Lending to agriculture and micro and small enterprises require specialisation as it enables cost reductions – information, transaction and others. We suggest the following policy alternatives to widen the financial access in the economy especially to unorganised segments.

One, issuing PSL certificates that are tradable in the market is one of the policy alternatives that government can think of as it allows some of the banks to specialise in the unorganised segment. Specialisation is essential for reducing the cost of lending so as to expand financial access to unorganised segments.

Two, banks can be encouraged to think of linking borrowings to savings through innovative deposit schemes and insurance products to reduce risk.

Three, local area banks with local employees and decentralised decision making procedures is another policy alternative. Such banks would be in a better position to lend smaller amounts at lower costs to rural unorganised segment including agriculture given their local knowledge.

For any further information, please contact the Academic Programmes Officer | academic@iegindia.org

Institute of Economic Growth
University Enclave, University of Delhi (North Campus) New Delhi 110 007
Phone 91-11-27667424/7570

www.iegindia.org