

## Financial Liberalization and Firm's Choice of Financial Structure: Some Indian Evidence

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*This paper analyses the effect of financial liberalization, particularly equity market reforms on firm's choice of financial structure. The paper approaches the question with the use of two concepts: traditional sources and uses of funds and a concept of "marginal propensity towards debt", which measures the proportion of cash flow deficit being financed by debt. Our result provides some insight into the validity of received wisdom in explaining the behaviour of Indian corporate in response to the increasing "marketization" of financial system.*

### I Introduction

Until 1992, the Indian corporate sector faced several constraints on its choices regarding sources of funds. Access to the equity market was regulated by the Controller of Capital Issues (CCI), an agency under the Department of Company Affairs, which imposed relatively severe conditions on firms wishing to raise funds through the equity route. Long-term debt was largely under the purview of the public sector Development Financial Institutions (DFIs) which, either through direct lending or through refinancing arrangements, virtually monopolized the supply of debt finance to the corporate sector.

In May 1992 (two months into the financial year 1992-93), as part of a sweeping set of reforms relating to the equity market, the CCI was abolished and access to the equity market was made much less restrictive, subject only to meeting certain technical conditions, and not to any formal approval process as had been the case earlier (see Gokarn, 1996 for a description and analysis of equity market reforms). On the debt front, institutional reform was much less significant, in the sense that the DFI monolith remained virtually intact. However, there was some reform in interest rate policy, with the institutions increasingly being given the freedom to determine their structure of interest rates.

Therefore, beginning in May 1992, and increasing in scope over the next two years or so, the Indian corporate sector found itself facing a choice set of sources of finance that closely resembled the stylized picture of an unrestricted capital market that underpins the financial structure literature. This transition provides the basic motivation for this paper. The question being addressed is: having transited from a relatively constrained to a relatively unconstrained choice set of sources of finance, how has the Indian corporate sector responded by way of capital restructuring?

The empiric framework used in this paper proceeds in two steps. The first step is to get a broad view of the changing pattern of financial structure choice over the sample period by using aggregate sources-of-funds analysis. The objective here is to derive certain stylized facts about the financial structure choice and also to study the stability of this choice over the reform period, which corresponds roughly to the early years of

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