

Development of Capital Market and Bank-centric Industrial Finance in India

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In the light of gradual development of financial market during the last three decades, this paper analyses the impact of the changing financing system structure of India on the financing pattern of Indian manufacturing firms, both at macro and firm levels. The longitudinal econometric analysis indicates that with the development of capital market, the bank credit intensity of industrial output has reduced and there is no significant impact of corporate bond market development on the manufacturing firms' credit intensity of output. Further, the firm-level evidences suggest that while for larger firms, the financing pattern remained broadly unchanged since liberalization, the smaller firms are increasingly moving towards other sources of financing such as inter-corporate borrowing.

I Introduction

The interdependence between the financial sector and the real sector is well established by empirical findings though there have been debates on the direction of causality in such a relationship (Patrick 1966, Goldsmith 1969, Jung 1986, Rousseau and Wachtel 1998). There are three main ways in which efficiency of the financial sector can foster economic growth (Garcia and Lin 1999). First, an efficient financial market stimulates savings by providing a greater choice of financial products. Second, the information and transaction costs decline as the financial sector becomes efficient. Third, development of financial markets fosters efficient allocation of resources by enabling investors to distinguish between investments and lenders in screening projects (Diamond 1984, Boyd and Prescott 1986). The issue of efficient resource allocation assumes special importance in the case of developing countries where the financial sector often caters the structural transformation of the economy.

The existing literature on the impact of financial market development on industry mainly analyses cross-country variations. The static framework adopted by most of the past studies limits the scope of analysing the effect of evolving financial market structure on financing pattern of industries. Though the

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