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## Financialization and corporate investments: The Indian case

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## Working Paper No. 828

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### **Financialization and Corporate Investments: The Indian Case<sup>\*</sup>**

by

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<sup>\*</sup> The authors previously published a newspaper article on the same theme, titled "What Deters Investment Today?" in The Hindu (Delhi), September, 10, 2014.

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**Abstract**

Financialization creates space for the financial sector in economies, and in doing so helps to raise the share of financial assets in the portfolios held by market participants. Largely driven by deregulation, the process works to make financial assets relatively attractive as compared to other assets, by offering both better returns and potential capital gains. Both the trend toward a more financialized economy and the expected returns on financial investments have provided incentives to corporate managers to invest larger sums in financial assets, resulting in growth of the share of financial assets relative to other assets held in portfolios. Assets held in the financial sector, however, failed to generate asset growth for the corporates. The need to obtain resources by borrowing in order to meet current liabilities reflects a pattern of Ponzi finance on their part. This paper traces the above pattern in corporate holdings of assets and its implications, with emphasis on the Indian economy.

**Keywords:** Corporate Investments; Financialization; Ponzi Finance; Speculation

**JEL Classifications:** E44, G32, L21

## **1 INTRODUCTION**

It is common knowledge that new investments in an economy relate to equities issued in the primary market as Initial Public Offerings (IPOs). The remaining stocks, which are usually listed in the secondary market, in effect represent transactions in old stocks which had been issued earlier in the primary market as IPOs. This distinction is important for identifying new investments in an economy.

## **2 CORPORATE INVESTMENTS IN ADVANCED ECONOMIES**

Earlier research on the investment decisions of large corporates in advanced economies revealed a pattern of an “owner-manager” conflict in the portfolio decisions of corporations. This conflict is characterized by shareholders, on the one hand, typically preferring short-term profitability and low investment in capital stock. This strategy is opposed to long-term investments and growth over time. This preference is also responsible for what has been described in the literature as a “growth-profit” trade-off in the firms’ business decisions (Crotty, 1990).

Looking at firm behavior, it is notable that corporate managers often become aligned with preferences of shareholders (i.e., short-term profits rather than long-term growth). These managers also respond to the currently popular market-oriented remuneration schemes, with bonuses and/or salaries paid in employee stock options under employee stock ownership plans (ESOPs) based on the balance sheet performance of their firms. As a consequence “...the traditional managerial policy of “retain and invest” is replaced by the shareholder-oriented strategy of “downsize and distribute” (Hein, 2009).

In relation to the increased power of shareholders in recent decades, attention has been drawn to the trend of a simultaneous drop in investment and accumulation by firms. Paradoxically, in the advanced economies, this trend has been accompanied by higher profitability for firms favoring financial investments.

As noted above, “...shareholder value orientation has had a significant effect on corporate behaviour” (Stockhammer, 2005–2006, p 199). This change in orientation entails “...a marked shift in the strategic orientation of top corporate managers in the allocation of corporate resources and returns away from ‘retain and invest’ to ‘downsize and distribute’” (Lazonic and

O'Sullivan, 2000, p. 18). By following this strategy, corporate firms have been rewarded by the financial markets with higher shareholder value (ibid).

Turning to the post-Keynesian theory of firms, which places firms firmly within their “institutional setting,” it has been pointed out that the decision by corporations regarding how to invest a share of their profits depends on the relative weight of the three major interests within firms. These include (1) the shareholders (interested in high profits and rising share prices), (2) workers (who want output growth with employment), and (3) managers (who receive fixed salaries plus performance-related payments linked to share prices and profits). Returning to the “shareholder revolution,” in which shareholders have greater power, it is not difficult to explain why firms, led by managers, adopt a business strategy that is less focused on long-term investment and more on short-termism (i.e., boosting share prices and profits) (Stockhammer 2005–2006). Observations of this trend are abundant in the literature and have likewise been verified using statistical evidence pertaining to the advanced economies. As has been observed by Stockhammer (2004) and others, “...financialisation has caused a slowdown in accumulation” (See Stockhammer 2004; van Treeck 2008; Organhazy 2006). The effects of this trend are also visible in the “...rising share of interest and dividends in profits of non-financial business,” confirming the emergence of rentiers who live on past rather than on current activities” (Power et al. 2003).

These developments can be treated as “...an indicator for the dominance of short-term profits in firms’ or in managements’ preferences” (ibid.). And as can be inferred, such shares appropriated by the rentiers are “...negatively associated with real investment” (Hein, 2009). Empirical evidence from the advanced economies (Power et al. 2003) makes it plain that the rising rentier income shares in profits earned by corporates do not necessarily generate “finance-led growth” in the real economy, unless, of course, rentiers have a consumption propensity that is higher than the national average, which is unlikely (Boyer 2000).

We observe that the broad conclusions in terms of the conceptual and the empirical description of corporate behavior in the advanced countries under financialization are consistent with the prevailing trends in developing countries where the corporates play a major role in shaping industrial performance. However, while the preceding analysis explains the ongoing tendencies of corporates to invest a smaller proportion of their profits in the real economy, it does not explain what becomes of the remaining portion of profits. Nor does it consider uncertainty as an important factor in explaining investment in alternate channels, which are

largely focused on speculative investment (Stockhammer 2005–2006, p. 208). Our analysis attempts to address these gaps by tracing the pattern of such residual investments. These residual investments consist primarily of short-term financial assets that offer the prospect of higher returns and capital appreciation. This pattern is consistent with the Minskyan tradition in the post-Keynesian literature, which treats uncertainty in deregulated markets as a major factor behind speculation in capital markets and the related short-term investments. The balance of this paper examines the pattern of corporate investments, specifically in the context of financialization in the Indian economy, using our analysis of advanced economies and the Minskyan extension suggested above.

### **3 FINANCIALIZATION IN THE INDIAN ECONOMY**

Financialization has, for some time, had a marked presence in India, especially with the steady opening of the financial sector in recent decades (See Sen 2014, pp. 318–320). As can be readily observed, India has initiated major changes in the pattern of corporate governance, in many ways replicating the changes seen in advanced economies. For example, Indian corporates have a marked tendency to hold financial assets as a rising proportion of their portfolio. Corporate firms in India also demonstrate a tendency to invest more in speculative financial assets, thus trading off long-term growth prospects for short-term profits.

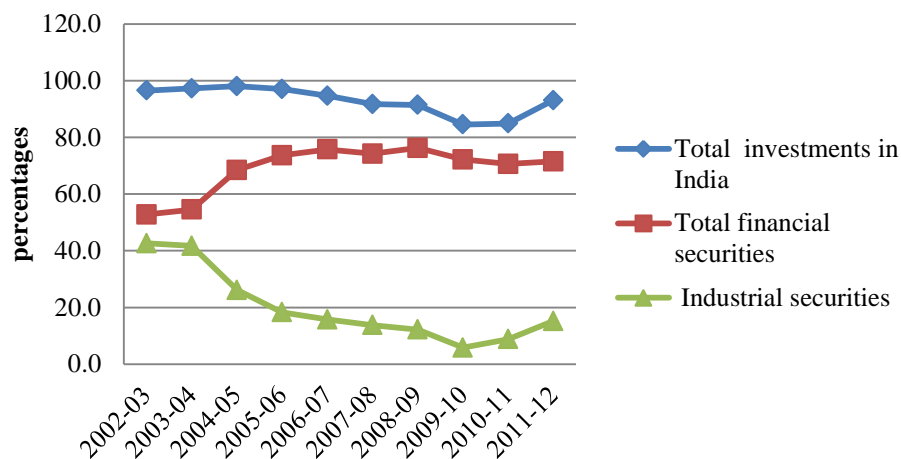
These same tendencies can be observed in the portfolio holdings of Indian public limited companies (“corporates”). As data from India’s central bank (the Reserve Bank of India or RBI) indicate, there has been a steady rise in financial securities as a proportion of total assets held by Indian corporates in the decade ending in 2011–2012, as well as proportionate declines in shares held relating to industrial securities. Industrial securities dropped from 40 percent in 2002–2003 to 15 percent by 2011–2012 and thereafter. In stark contrast to these declines, the proportion of financial securities as a share of the assets held by corporates rose from less than 60 percent to 70 percent (and higher) over the same period.

As opposed to the declines presented above, the proportion of financial securities in assets held by the corporates has moved up, from less than 60 percent to 70 percent (and above) over the same years (Chart 1). Financial securities, as detailed above, include securities issued by the government, and by financial institutions, plus debentures.

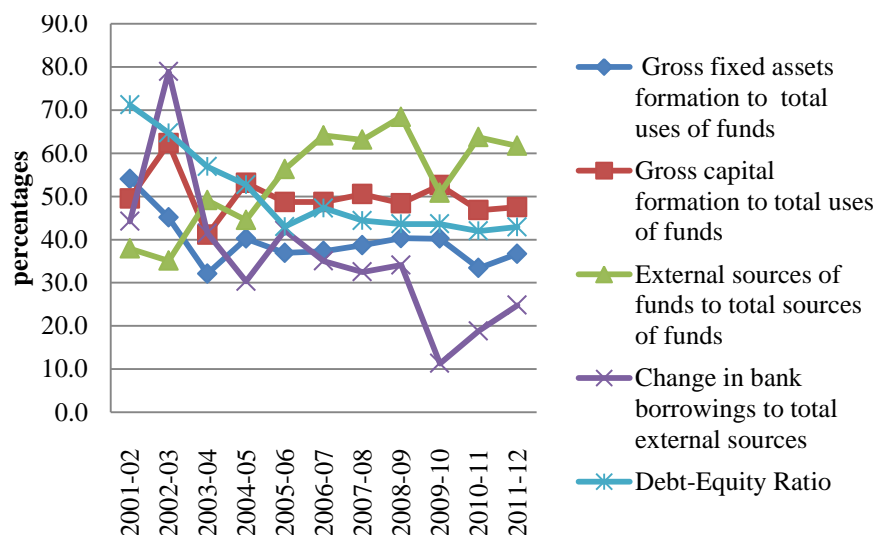
The changes in the pattern of investment by the Indian corporates are also reflected in the formation of fixed assets and in capital formation by corporates. The share of funds used by the corporates over the last decade for investment in fixed assets and capital formation has clearly declined.

In terms of the sources of funds, corporates have recently been borrowing more from external sources and proportionately less from domestic banks. The rising share of external borrowing (Chart 2) makes up for the declining share of bank borrowing, and leads to debt-to-equity ratios which have remained roughly at the same level for the last five years.

*Chart 1 Investments by Indian Corporates*



*Chart 2 Sources and Use of Funds and Debt/Equity Ratios for Corporates*



Source, charts 1-2: Reserve Bank of India bulletins, various issues.

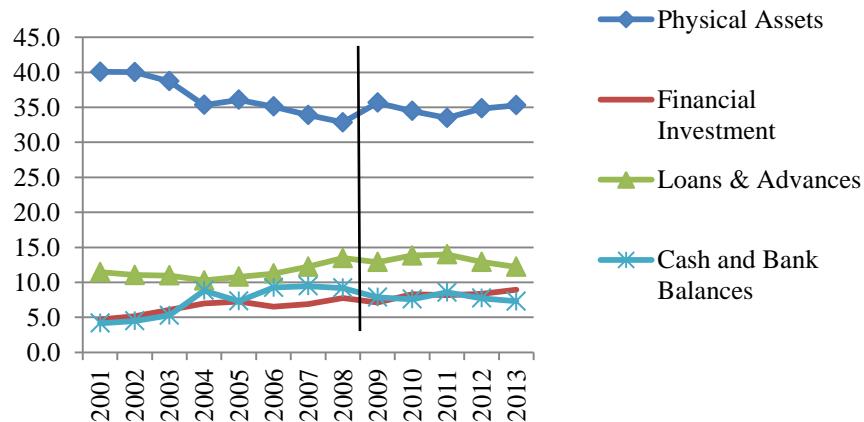
The above statistics (charts 1 and 2) on the flow of corporate investments drawn from the RBI data sources tallies with data relating to the changing stocks for similar categories relating to Indian corporates. We have obtained these statistics from the Prowess online data sources of the Mumbai-based Centre for Monitoring Indian Economy (CMIE). We present below (Table 1) the coverage of these data in terms of the number of firms included in the Prowess statistics for each year. Despite the coverages varying over time, we have used the dataset as time series magnitudes.

*Table 1 Coverage of Prowess Data*

Year	Number of Companies
2001	3968
2002	4420
2003	5612
2004	6181
2005	6731
2006	6865
2007	6906
2008	6869
2009	6929
2010	6750
2011	5644
2012	4794
2013	2630

Source: <https://www.prowess.cmie.com>

*Chart 3 Share of Various Components in Total Assets  
(as percentage)*



Source: Author's calculation from Prowess Database

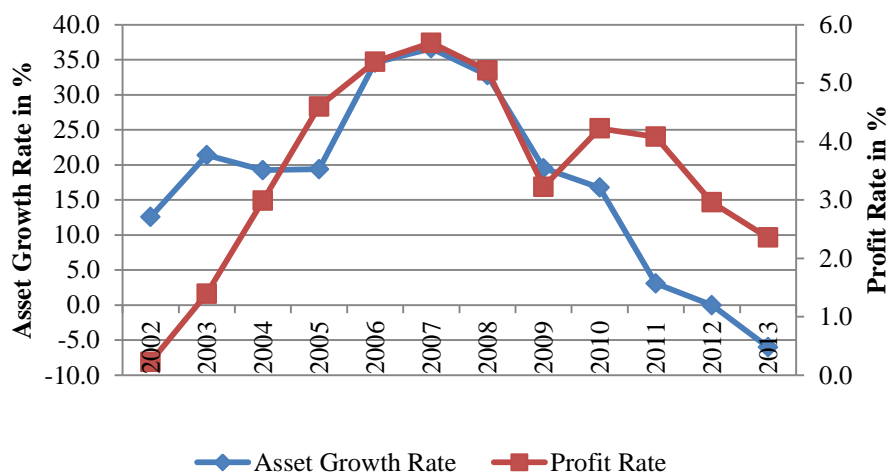


We can observe in Chart 3 that the Prowess data sources also indicate declines in the shares of physical assets held by companies. However, the drop in physical assets from 40 percent in 2001 to 35.3 percent by 2013 (Chart 3) seems to have been less compared to the declines in gross fixed assets as documented with RBI sources in Chart 2. The difference may be the result of methodological differences inherent in the two data sources, specifically relating to the coverage of firms for each year (Given that RBI sources do not disclose variations in coverage, we treat those as uniform while the Prowess data set varies in terms of coverage). On the whole, judging by the small and declining share of physical assets held by the corporates in both sources, contributions of such assets toward accumulation in the industrial sector seem to be visibly at a low ebb in the Indian economy.

The relatively small share of the physical assets shown in these data sources has been matched by a large and rising share of financial assets in the portfolio holdings of corporates. Evidently, the changes in the Indian economy indicate a unidirectional pattern in which investing in the real sector assumes a lower priority for private sector corporates.

Paradoxically, notwithstanding these tendencies of corporates to rely on the financial sector as their main investment channel, the growth rates of assets held by the corporates have shown a downward trend in recent years. According to the Prowess data sources, asset growth rates for corporates have sharply fallen, from 32.8 percent in 2008 to zero percent in 2012, and falling further to (-)6 percent in 2013. The profitability of assets has followed a similar path (Chart 4) and, with the exception of 2010, the profit rate has seen a steady decline from 5.7 percent in 2008 to 2.4 percent in 2013. The performance of the corporate sector has unmistakably been dwindling, not only in terms of its contribution to real investment but also in terms of the growth of overall assets and their profitability.

Chart 4 Growth Rates: Gross Assets and Profit rates on Assets



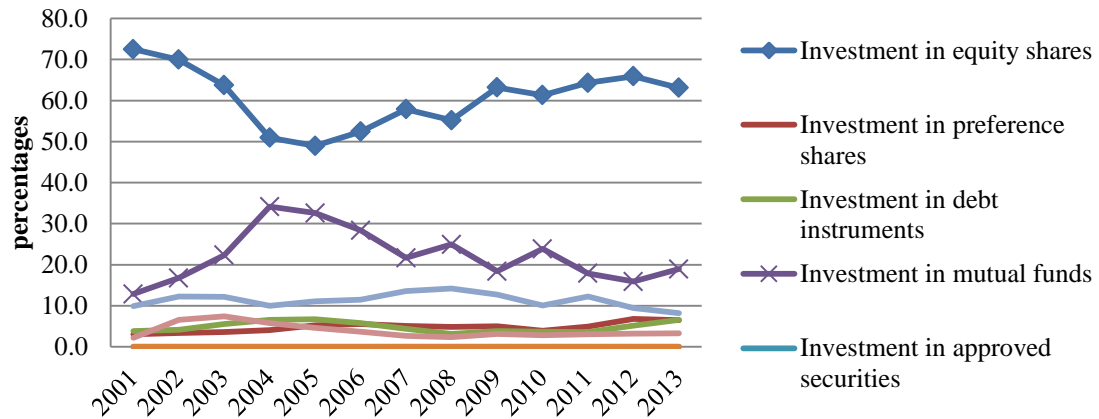
Source: Author's calculation from Prowess Database

The drop in asset growth rates and in the profit rates of assets held by the Indian corporates demands an explanation, especially in the context of the large share of financial assets held in their portfolios. How, in other words, have the financial assets been performing? And, in particular, why have these holdings failed to contribute to growth rates and profits on assets?

To uncover the causal link underlying these questions, we must examine the composition of the financial assets held. We must also pay attention to the changes in the liabilities held against the financial assets, which presumably could have shrunk the growth rates of assets.

Looking at the composition of the financial assets held by the corporates, the rising share was primarily driven by mutual funds until 2004, when it reached 34.3 percent of the total. After 2004, it was the rise in equities which contributed to the share of financial investments held by the corporates. By 2013, these two types of investments (equities and mutual funds) contributed as much as 82 percent of corporate investment in financial assets (Chart 5).

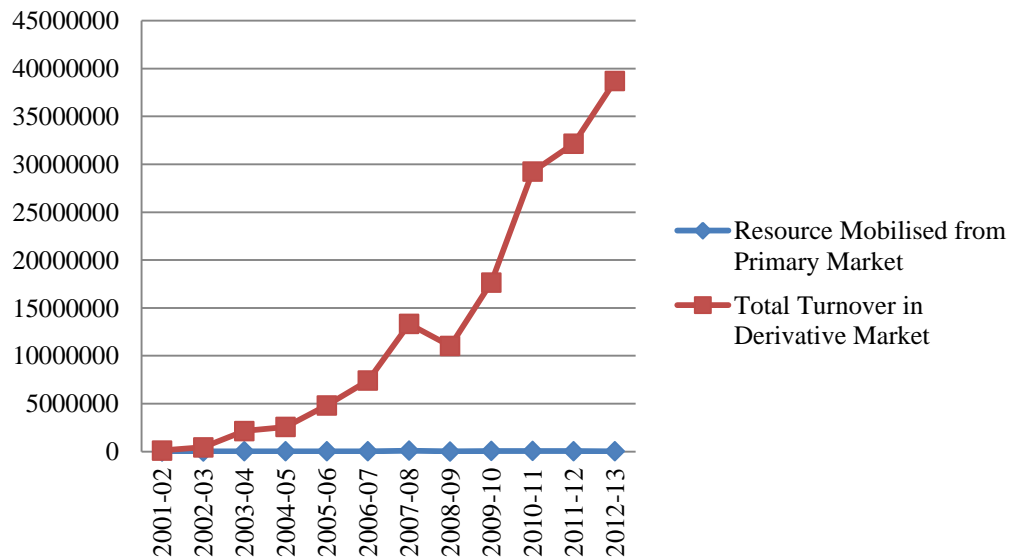
Chart 5 Share of Various Components in Financial Investment by Corporates



Source: Author's calculation from Prowess Database

Corporate investments in equities, including derivatives, were primarily transacted in the secondary market for stocks. The sharp increases in transactions of derivatives in the latter has overshadowed the role of the primary market in equities in India's capital market (Chart 6).

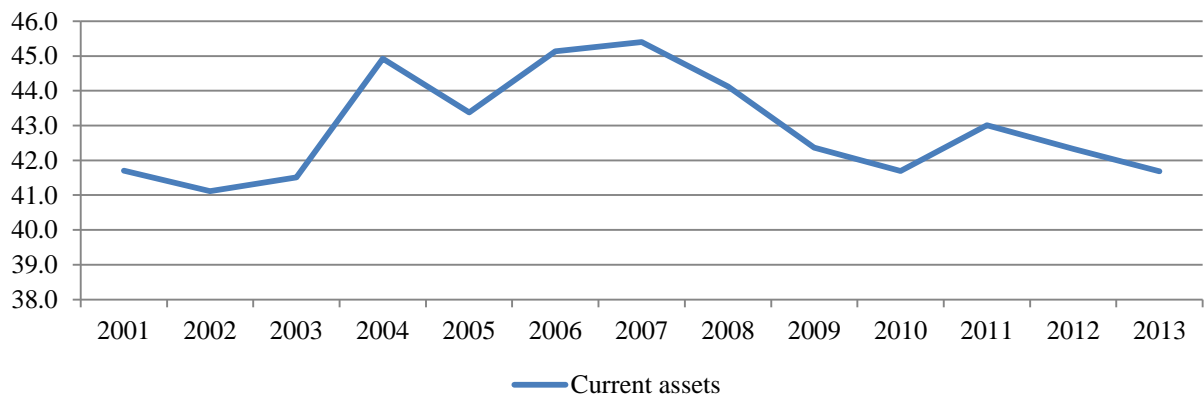
Chart 6 Investments in Primary market and in Derivatives (Rs Crores)



Source: SEBI annual report, various years

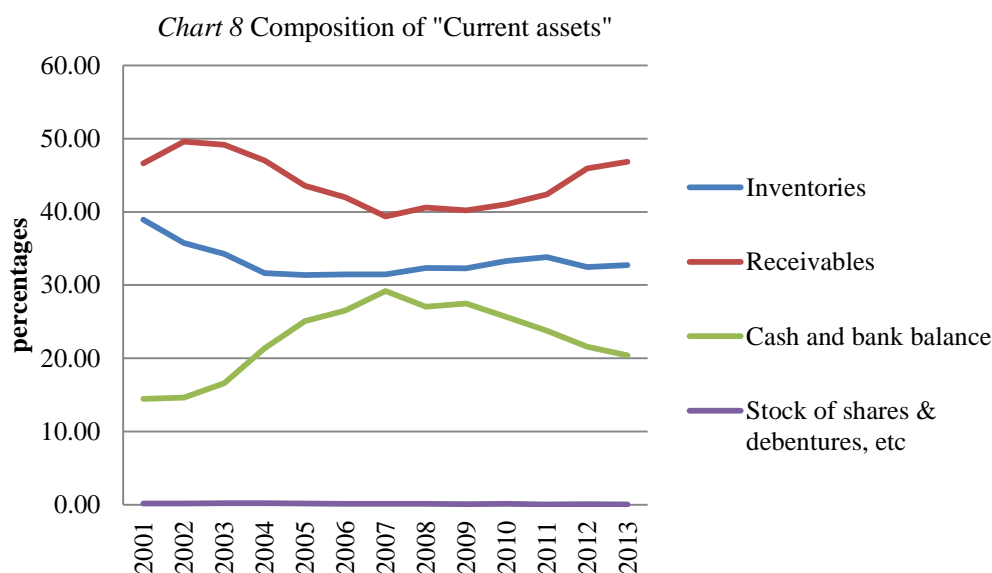
While Prowess data do not provide further information on the nature of the financial investments discussed above, one can, from the same sources, describe the sums for current (financial) assets, as those which provide returns within a period of 1 year or less (Chart 7). Most of these assets, however, consist of “cash and bank balances.” This is because derivatives are not adequately accounted for in the calculation of the current assets, while equities, as would be expected, have a rather small share in current assets. Thus a rise in the share of short-term investments is normally associated with a rise of cash and bank balances in total assets. This is because daily transactions in short-term assets require more liquidity. Thus, the sum of “current financial assets” can be treated as a proxy for short-term financial assets, the share of which has increased considerably in recent years. In addition, we must recall that equities and mutual funds (both financial assets) are also subject to transactions over short durations.

*Chart 7 Share of Current Assets (with Less than 1-Year Duration) in Total Financial Assets Held by Corporates*



Source: Author's calculation from Prowess Database

*Note:* Current assets as calculated here capture the value of all amounts due to the company as of the date of the balance sheet, and consist primarily of cash and bank balances.

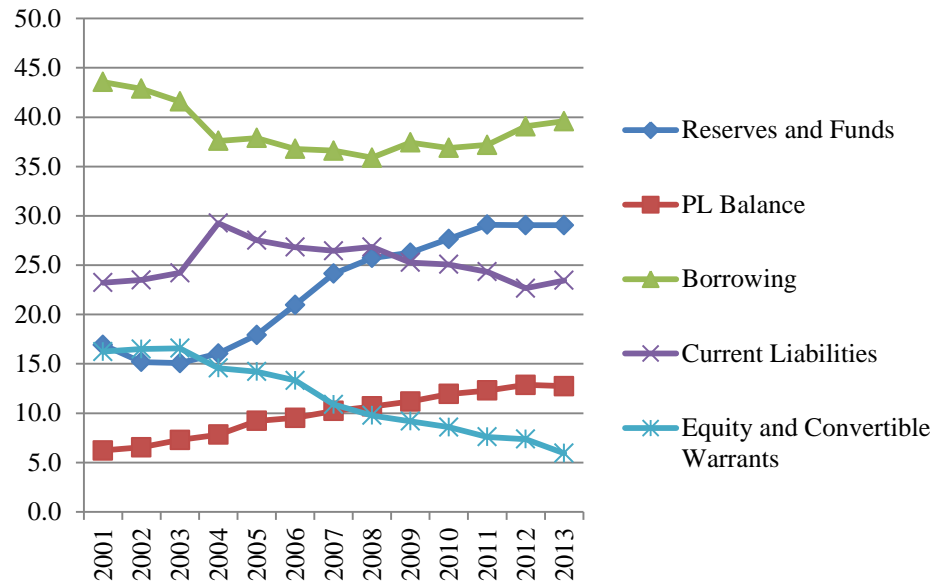


Source: Author's calculation from <https://prowess.cmie.com/>

*Note:* Data on 'receivables' captures the value of all amounts due to the company as of the date of the balance-sheet, and typically, on goods and services.

To explain the shrinking asset base observed for corporates, we examine the pattern of their outstanding liabilities. This effectively provides an indication of the sources of funds, including borrowings, use of reserves plus company funds and issue of equities, etc. Of these sources of funds (and rise in liabilities), the more significant items include the reserves and funds of corporate firms, followed by their borrowings. This is reflected in the rising share of liabilities between borrowings and reserves plus funds (Chart 9). The rise in reserves and funds, in turn, was driven by positive movements in profit/loss balance (a major component of reserves and funds) in the balance sheets of companies. A continued rise in their share between 2004 and 2011 has, however, stalled since 2012. Equities, which could have been a major source of acquiring resources for the firms, failed to provide much, as is seen in the declines in the respective share of equities (and convertible warrants) in total liabilities throughout 2001 to 2013. Simultaneously, equities failed to provide much in the way of resources over the decade, with their share in outstanding liabilities declining from 16.2 percent in 2001 to 5.9 percent in 2013. The unabated fall in the share of equity finance, along with a stagnant share of reserves during this period, evidently led firms to complement their assets with increased borrowings.

Chart 9 Shares of Various Components in Total Liabilities

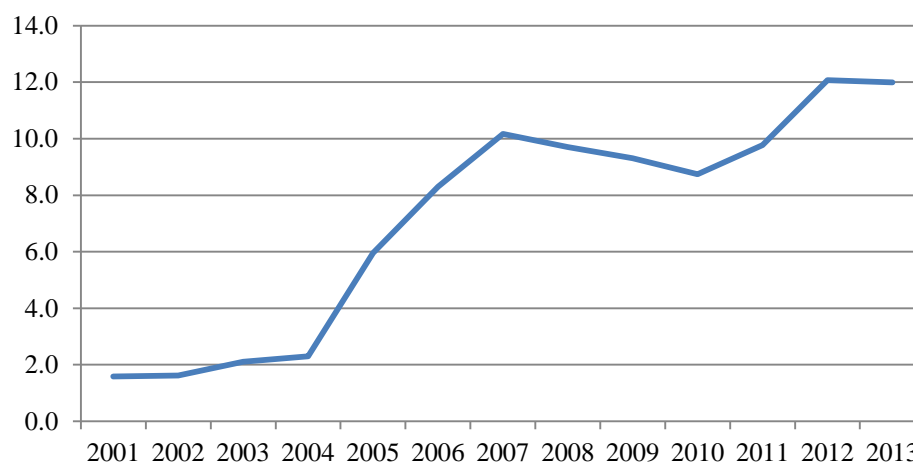


Source: Author's calculation from <https://prowess.cmie.com/>

We now turn to the use of funds by corporates, a large share of which has been used to meet current liabilities, which include dividends, interest payments, etc. With an increasing tendency for corporates to obtain funds by borrowing, the use of these borrowed funds was clearly directed to meet the kinds of liabilities mentioned above.

The increased share of borrowings, which of late have been a major source of financial resources for the corporates, started rising in 2010–2011 and continued thereafter. Its share, ranging between 43.6 percent in 2001 to 39.6 percent of total liabilities in 2013, seems to have provided a relatively easier option for corporates to meet their liabilities. Evidently, this change was facilitated by the liberalized norms for external borrowings. Evidence of this can be seen (Chart 10) in the steady upward movement in both external commercial borrowings and supplier credits as shares of aggregate borrowings by the country. We conclude that most of these external borrowings were undertaken by the corporate sector. It is also notable that the growth rate of bank credit to industry, as reported by the RBI, has steadily fallen from 24.4 percent in 2009–2010 to 14.9 percent in 2012–2013 (RBI 2013). An underlying factor might be the intermittent hikes in bank rates by the RBI.

*Chart 10 Percentage of Foreign Currency Borrowing in Total Borrowing*



Source: Author's calculation from <https://prowess.cmie.com/>

With borrowings generating a large share of current liabilities as discussed above, we observe a pattern which can be interpreted as a “Ponzi” mode, where fresh borrowings are used to meet the liabilities related to past borrowings and the sale of equities. We must also highlight another aspect of corporate finance which was discussed earlier. This relates to the tendency on the part of the Indian corporates to hold short-term financial assets as the most attractive form of investment, reflecting the decisions of the profit-oriented business managers who run the companies. Given these incentives, it is no surprise that the trade-off between growth and short-term profits at the level of the corporates in India has clearly tilted in favor of the latter.

## **4 CONCLUSION**

The tendency of corporates under financialization to prefer short-term financial assets (as opposed to long-term physical investments) is at the core of an explanation of the industrial stagnation that prevails in the majority of countries in the world economy at present. The explanations offered regarding the trade-off between growth and profitability under financialization, as mentioned in the literature, deal with the ongoing state in the advanced economies.

The present paper complements previous analyses by extending the discussion to India, a country well-integrated in the global financial system. As we observe, Indian corporates seem to

follow a path of short-termism in the face of uncertainty in deregulated financial markets. At the same time, the search for quick returns in high-risk, short-term assets deters investments in physical assets. The end result, however, has been that corporates have seen low growth rates in their gross assets. Does this not mean that the short-term financial assets had less capacity to contribute to further growth in assets?

Dwelling further on the related changes in India, we notice the tendency of corporates to borrow heavily from capital markets, both from within and outside the country. Borrowing from international lenders, along with the use of the company-level reserves and funds, provides the major source of their funds. This was a result of the failure of the primary stock market to provide sufficient resources via IPOs.

Borrowings, as discussed above, and the use of funds in tandem with reserves have provided the necessary resources to meet the current liabilities, including dividends, interest payments etc., that must be met in each period. We further observe that the tendency of corporates to rely on the financial sector, using borrowing to meet other liabilities, generates a Minskyan Ponzi finance (Minsky 2008) mode which is inherently unstable. The problem is further compounded by external borrowing, which adds to the related liabilities in foreign exchange. The problem is thus not only with continued borrowing to meet charges on past debts but also of a mismatch of currencies in meeting debt obligations.

The economy in India is thus increasingly exposed to problems which run much deeper than they appear on the surface. In addition to the ongoing stagnation in the real economy, which, as we have pointed out, has been directly affected by the ongoing pattern of corporate finance under financialization, the extensive borrowing used to meet the current obligations has sown the seeds of potential economic instability as a result of a growing trend of Ponzi finance.

Discounting the relatively high levels of financial activity with speculation in stock markets, currency trading, commodity markets and real estate, one notices the sources of instability, largely due to the ongoing pattern in corporate finance. Paired with a stagnating real sector and the visible disinclination of corporates to invest therein, the Indian economy cannot expect a turnaround in the near future. Such a turnaround requires an overhaul of current public policy away from financialization and in favor of the real economy.



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