

# Financialisation and Corporate investments - The Indian Case

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# The Background

- Financialization , by creating multiple channels of financial investments, helps to raise the share of financial assets in the portfolios held by market participants. Driven by deregulation, it works to make financial assets relatively attractive . Also provides incentives to corporate managers to invest larger sums in financial assets , which, how ever, often fail to generate asset growth for the corporates.
- Obtaining resources by borrowing in order to meet current liabilities , in absence of other sources like equities reflects a pattern of Ponzi finance ,as in the current scene in the Indian economy.

# Corporate Investments In Advanced Economies

- Investment decisions of large corporates in advanced economies reveal a pattern of an “owner-manager” conflict in the portfolio decisions of corporations.
- Conflict characterized by shareholders typically preferring short-term profitability and low investment in capital stock...a strategy opposed to long-term investments and growth over time, which is ultimately in interest of owners in long run. . Responsible for a “growth-profit” trade-off in the firms’ business decisions
- Decision by corporations depends on the relative weight of the three major interests within firms. :
  1. 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 which are linked to share prices and profits).

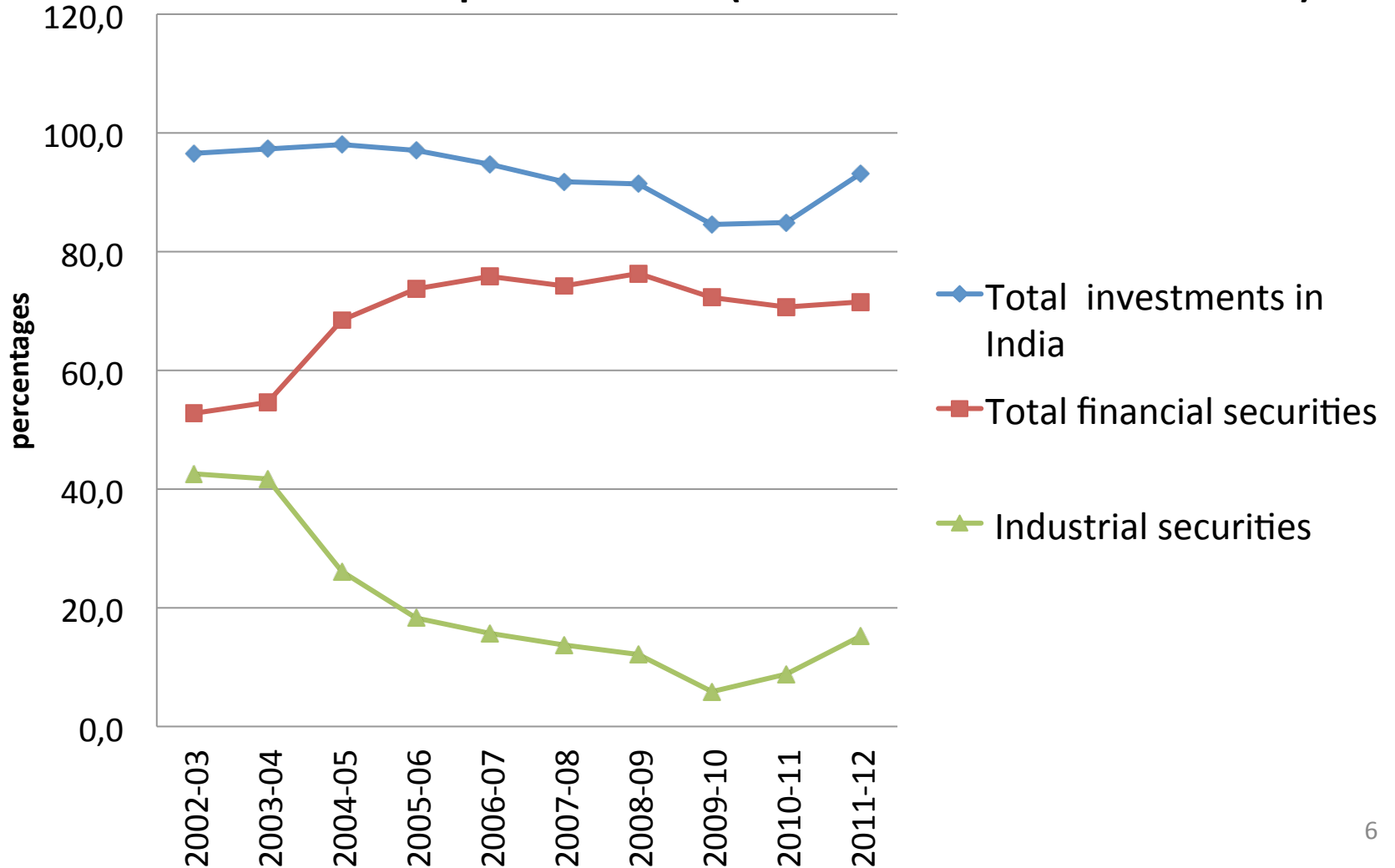
# Alignments: Corporate managers and shareholders

- “shareholder revolution,” has lent greater power to shareholders who are often less interested in long run growth.. Managers, aligned to interests of shareholders, adopt a business strategy less focused on long-term investment and more on short-termism which boosts share prices and profits .... Managers also respond to market-oriented remuneration schemes for bonuses and/or salaries paid in employee stock options (ESOPs) based on 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).
- Verified with statistical evidence on advanced economies, “...financialisation has caused a slowdown in accumulation” (See Stockhammer 2004; van Treeck 2008; Organhazi 2006). Consequences include “...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).
- Simultaneous drop in investment and accumulation by firms. Paradoxically higher profitability for firms favouring financial investments

# Prowess data ( Source: Centre for Monitoring Indian Economy, Mumbai)

- The prowess has broadly categorized total assets of corporates into 5 parts : a) net fixed asset , b) capital work in progress c) financial investment, d) Loans and Advances and e) Cash and Bank Balances.
- Component (b), which is the capital work-in progress, is the fund used for the formation of fixed assets which are yet to be completed.
- Components (a) and (b) can be clubbed to define “physical assets”.
- Total Asset - Physical Asset  $(a+b) = (c)$  Financial Investment +  $(d)$  Loans and Advances +  $(e)$  Cash and Bank Balances
- Thus leaving out physical assets, rest are generally financial.

**Chart 1 Investments by non-government public limited companies in India( Source: Reserve Bank of India)**





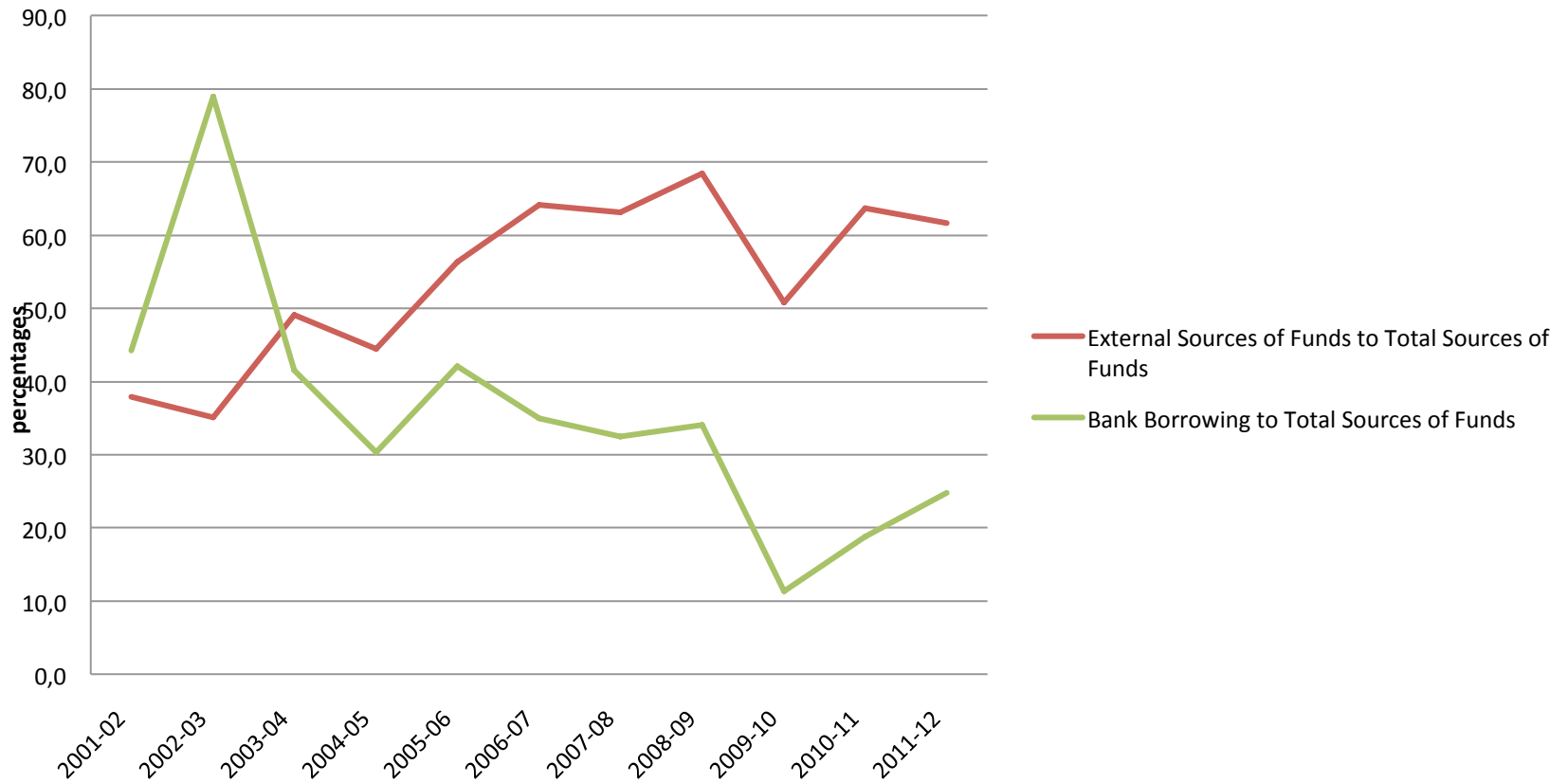
# Indian Corporates

- Corporate investments in India less than 100%. Rest invested abroad.
- Financial investments larger than industrial investments.



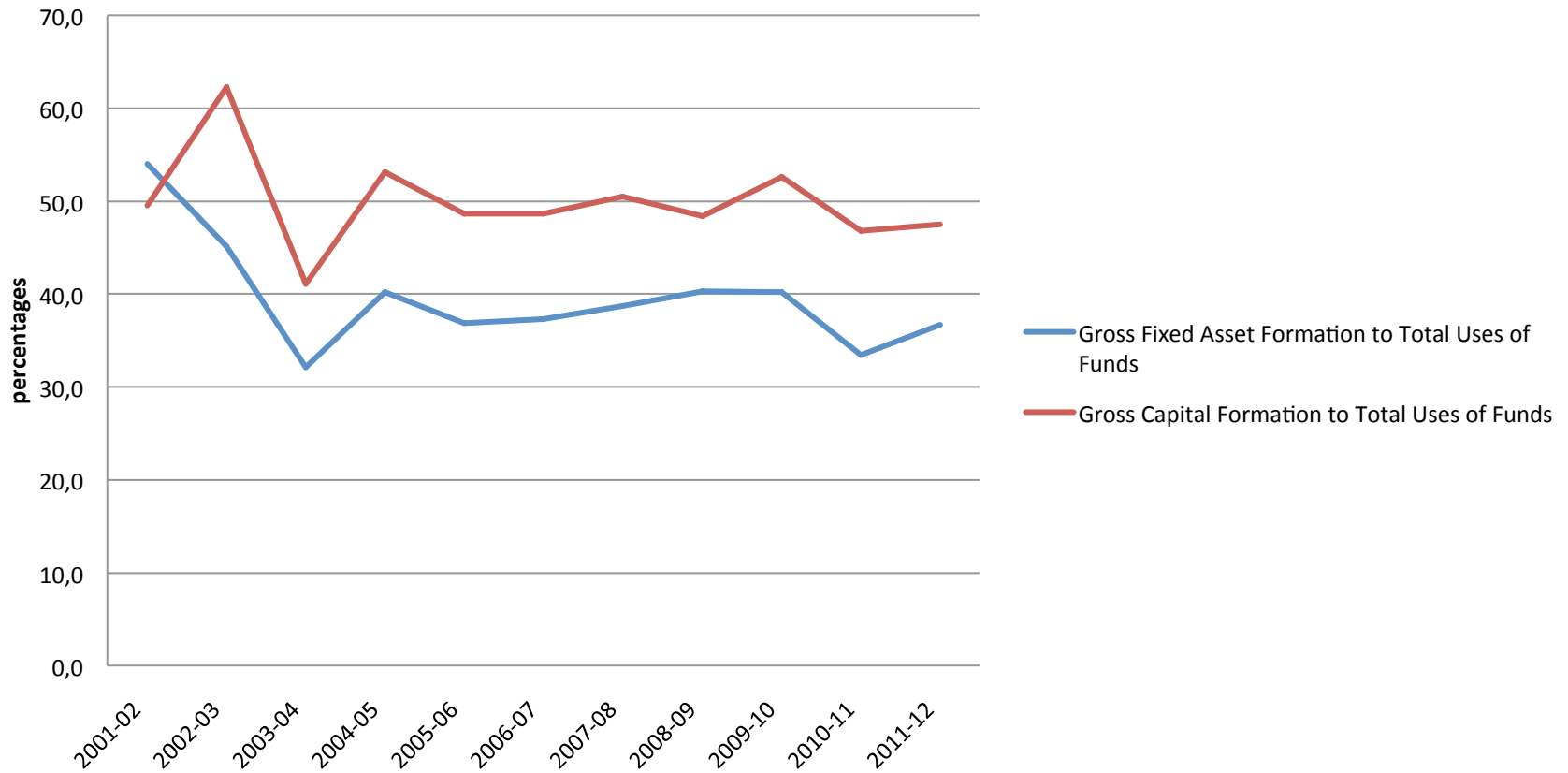
# Chart 2 Sources of Funds for Corporates(RBI)

Sources of Funds

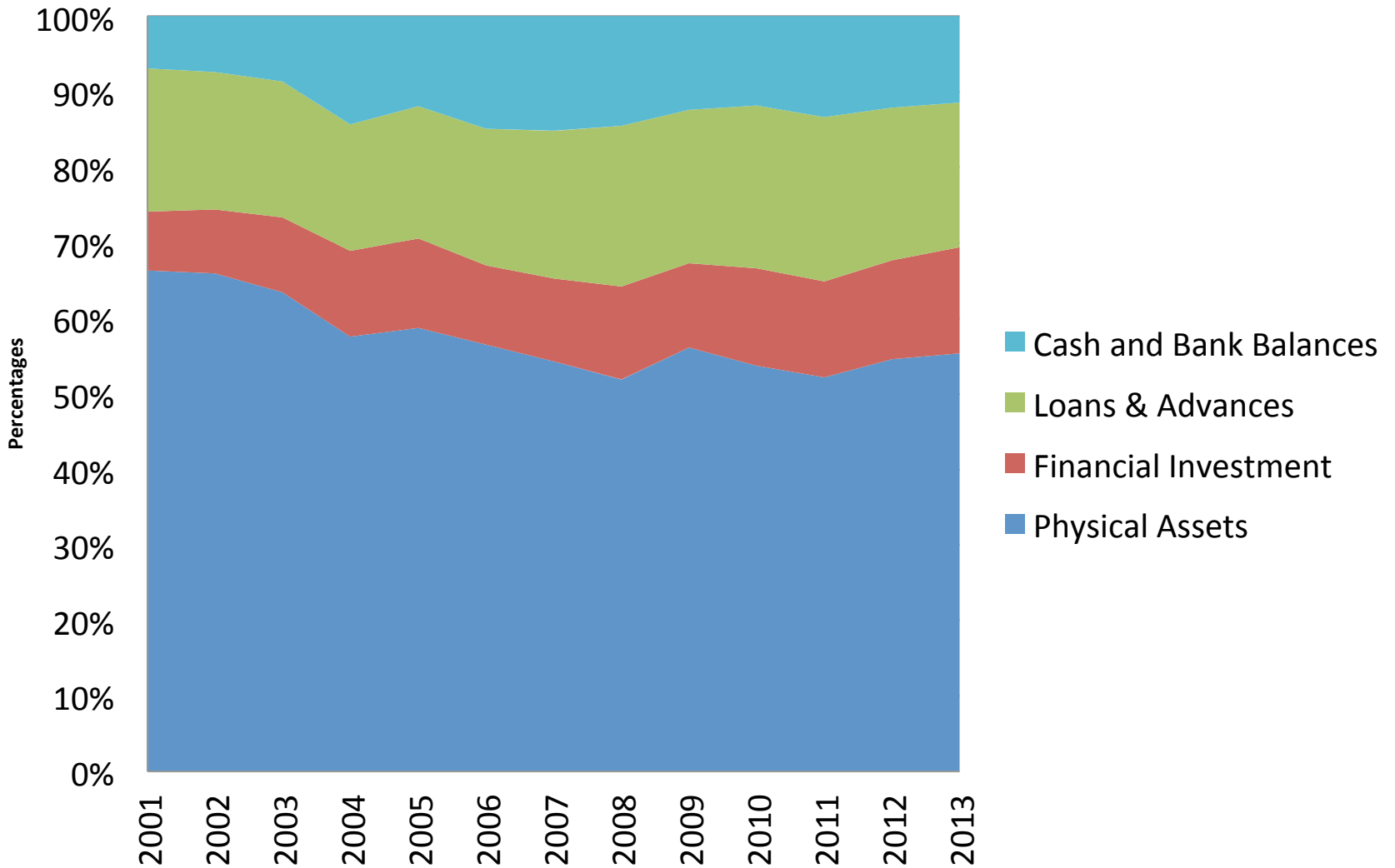


# Chart 3 Use of Funds by Corporates(RBI)

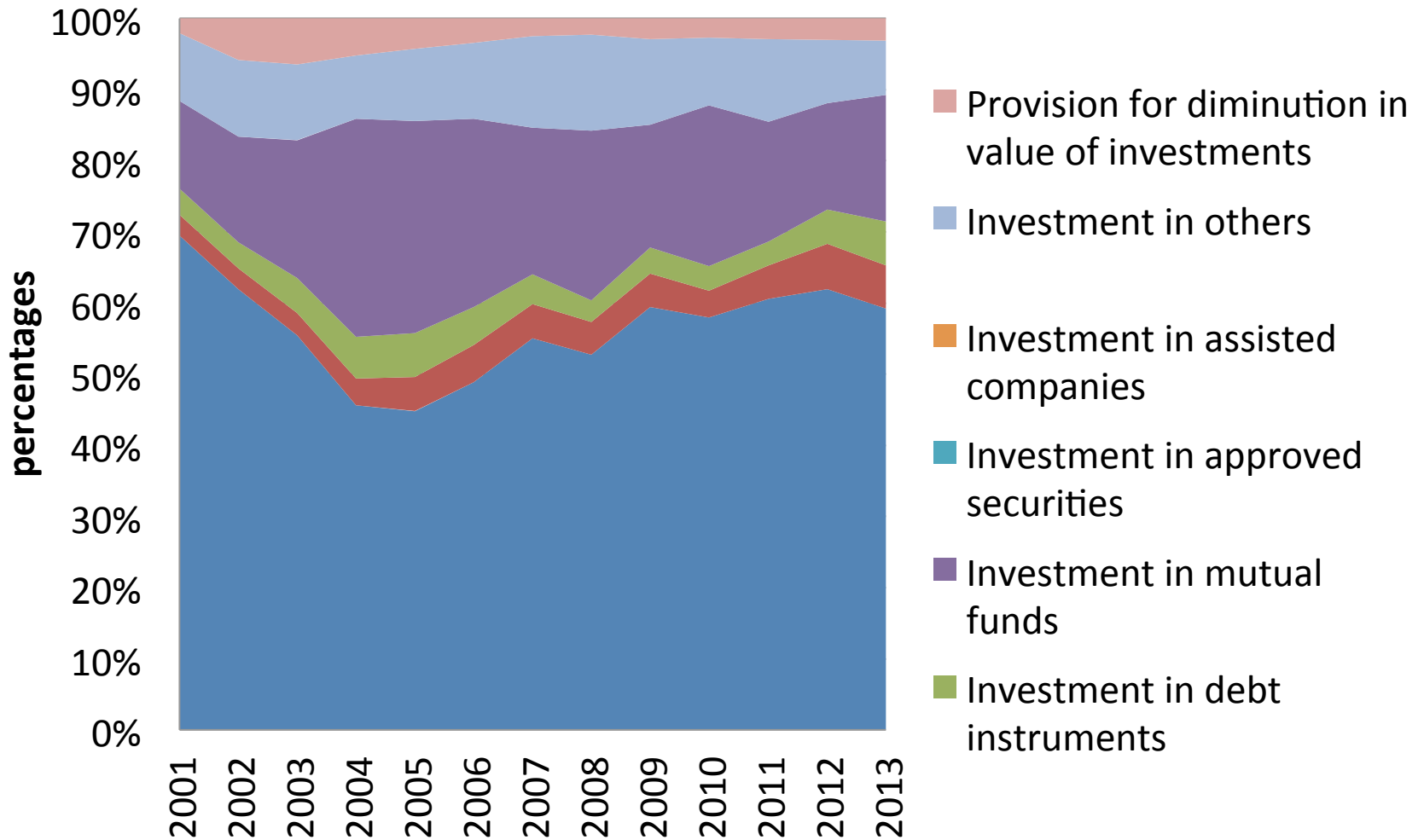
Use of Funds



**Chart 4 Share of Various Components in Total Assets ( Prowess))**



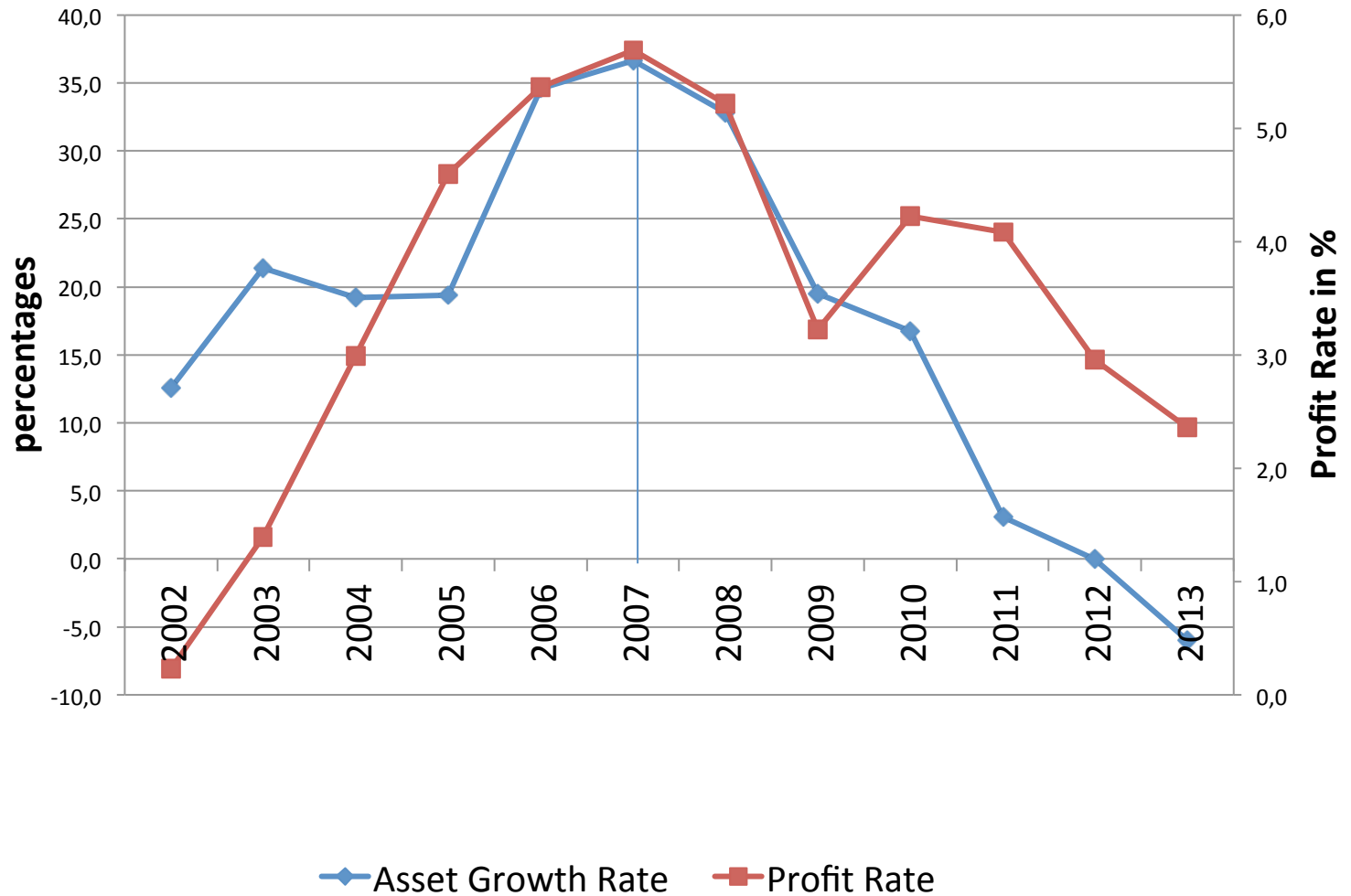
## Chart 5 Share of Various Components in Financial Investment by corporates



## Share of Various Components in Financial Investment by corporates

- Approved securities and mutual funds major components of financial investments by corporates. Both are short term.

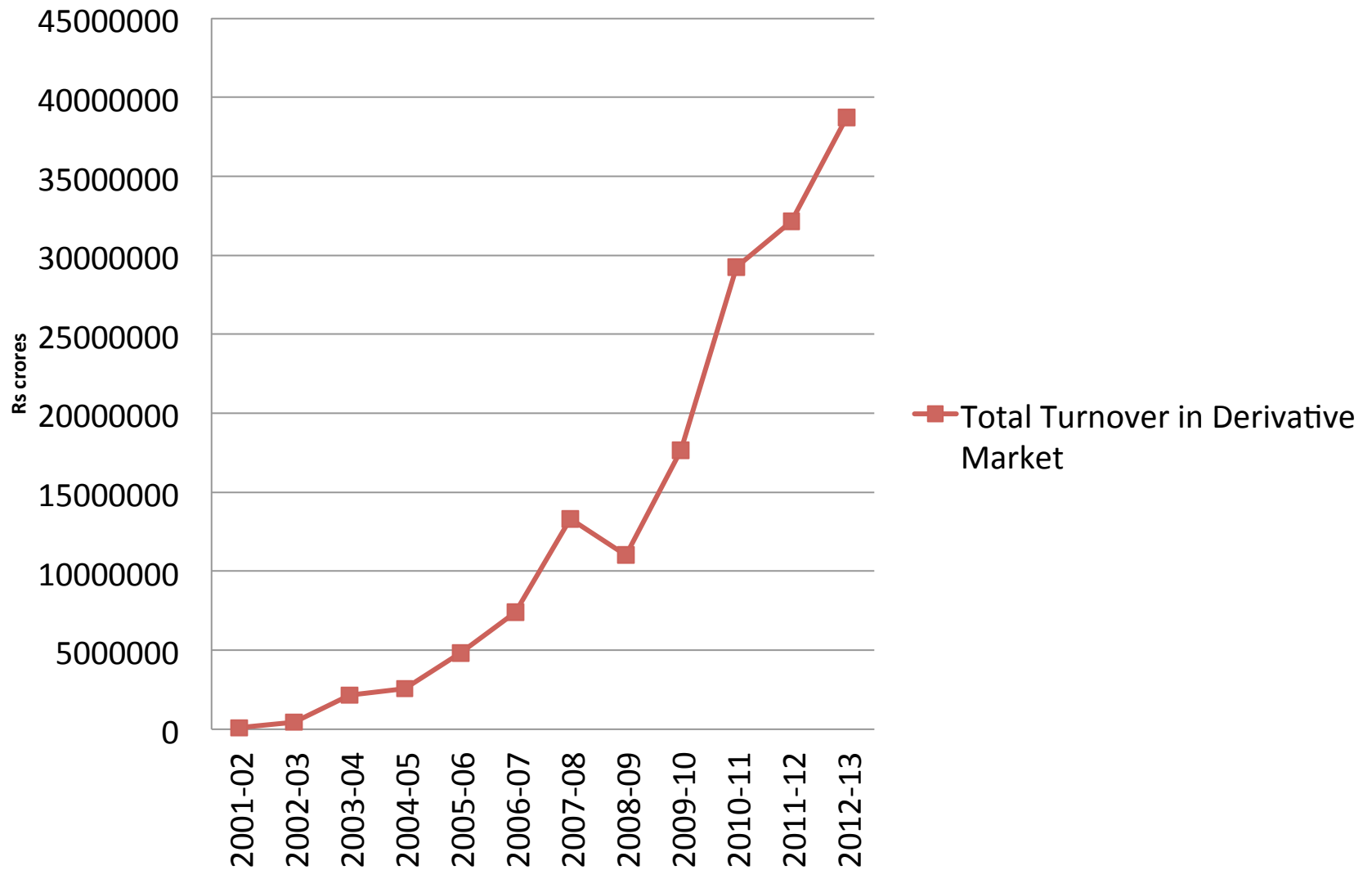
### Chart 6 Growth Rate of Gross Assets and Profit rates on Assets (Prowess)



## Growth Rate of Gross Assets and Profit rates on Assets (contd)

- Growth rates of both assets and profit rates fell sharply between 2007 and 2009.
- Recovery of profit growth rate in 2010 followed by declines in next few years.
- Why growth rates of both assets and profits decline despite large shares of investments in financial assets? Do those not perform due to the short run pattern?
- Contrast advanced countries with profit rates on assets rising while growth rate of assets falling.

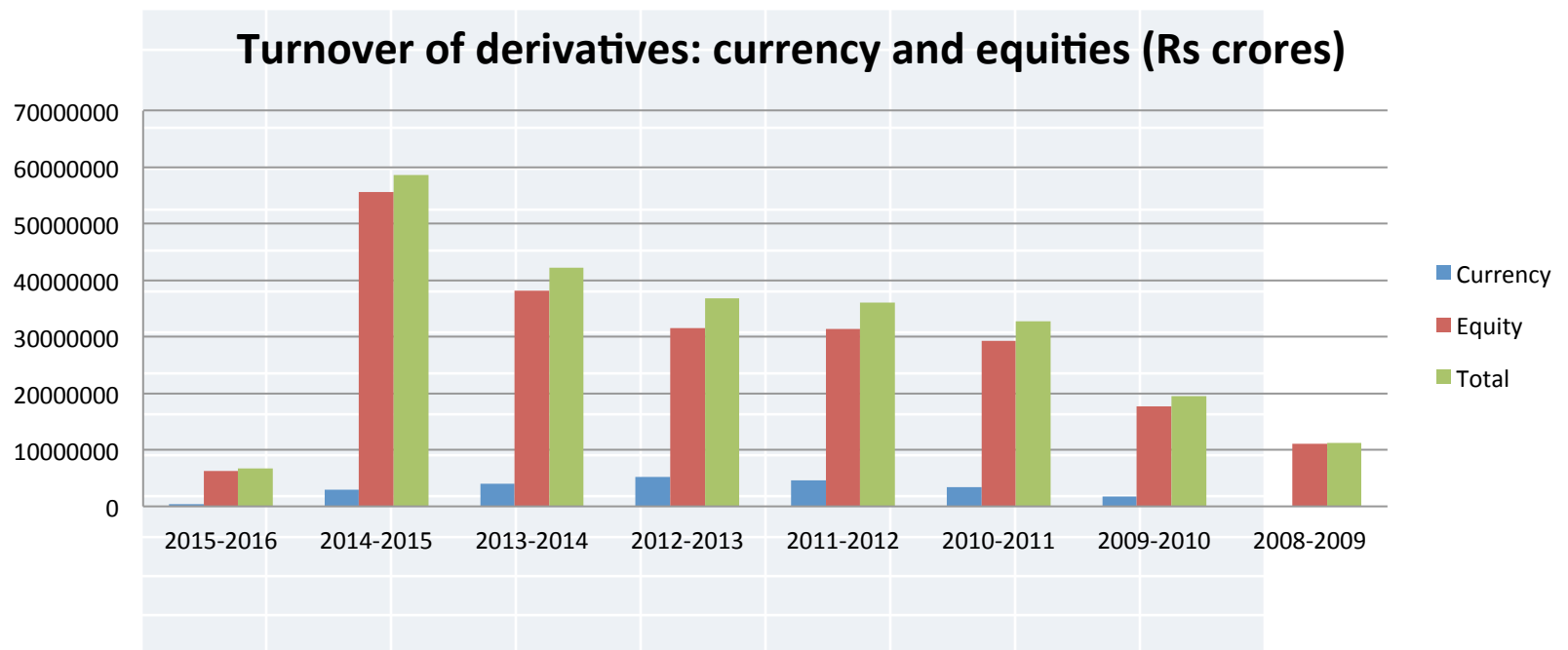
### Chart 7 Investments in derivatives ( SEBI)



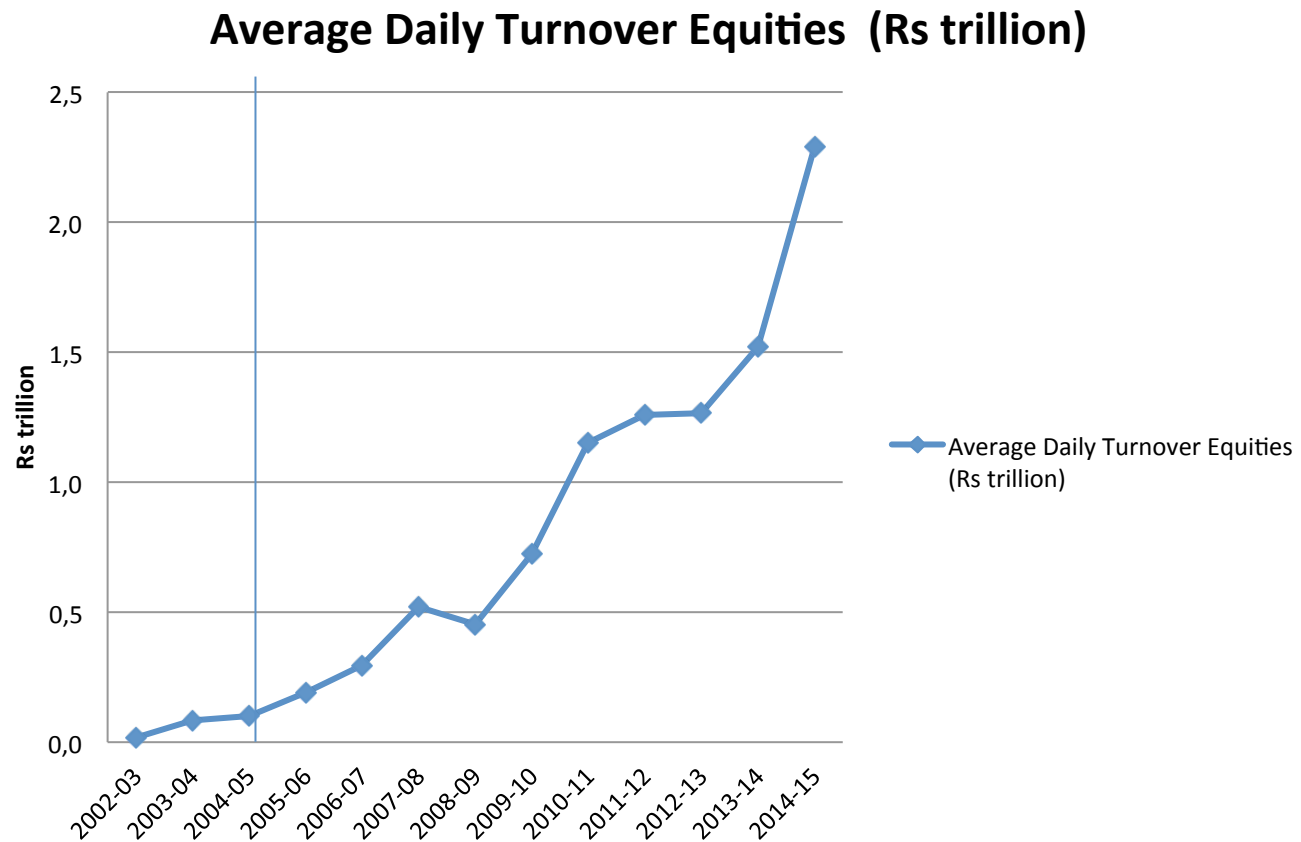


# Turnover of derivatives ( currency and equities)

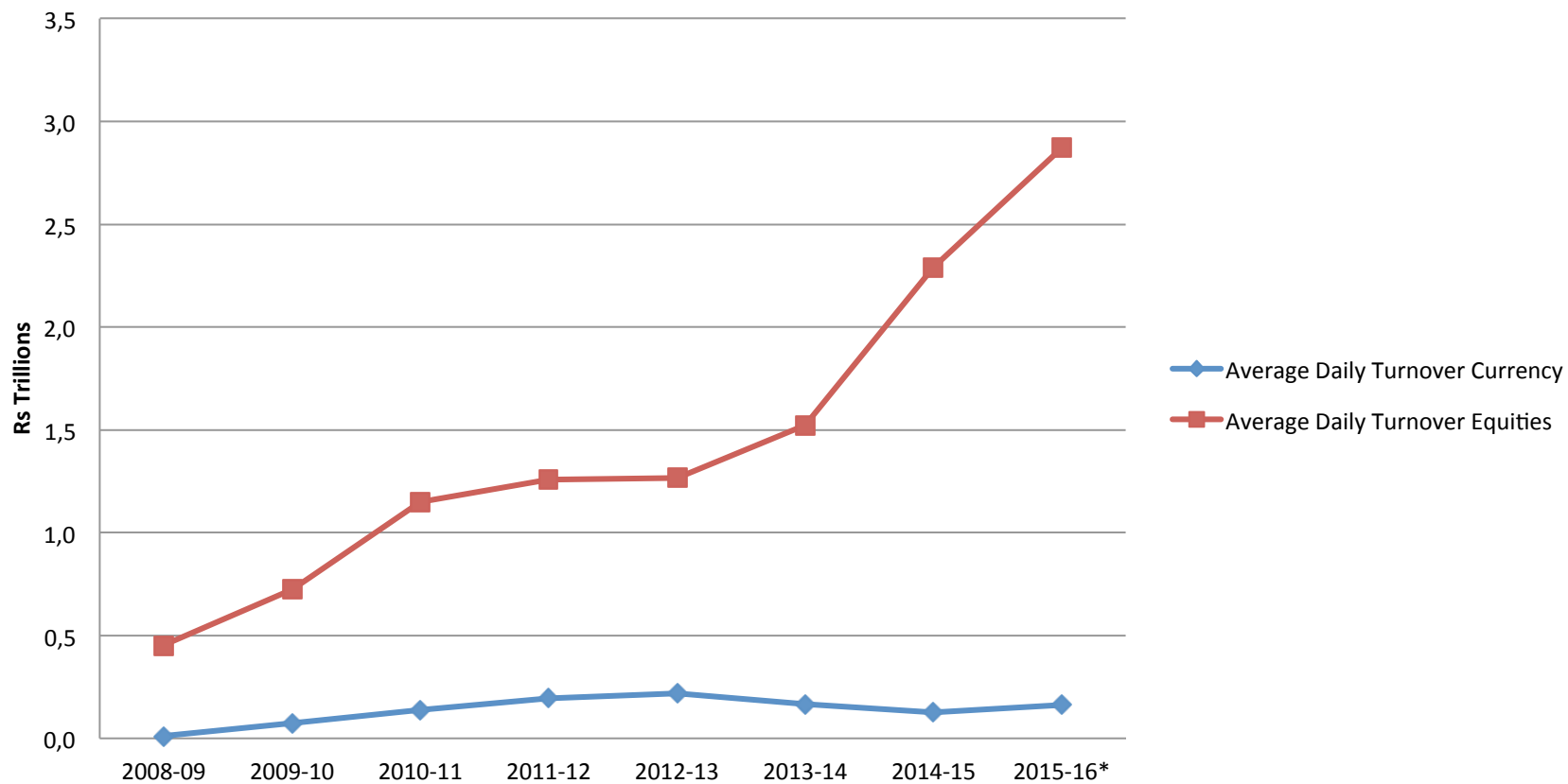
Source: SEBI



# Average daily turnover for derivative trading of equities

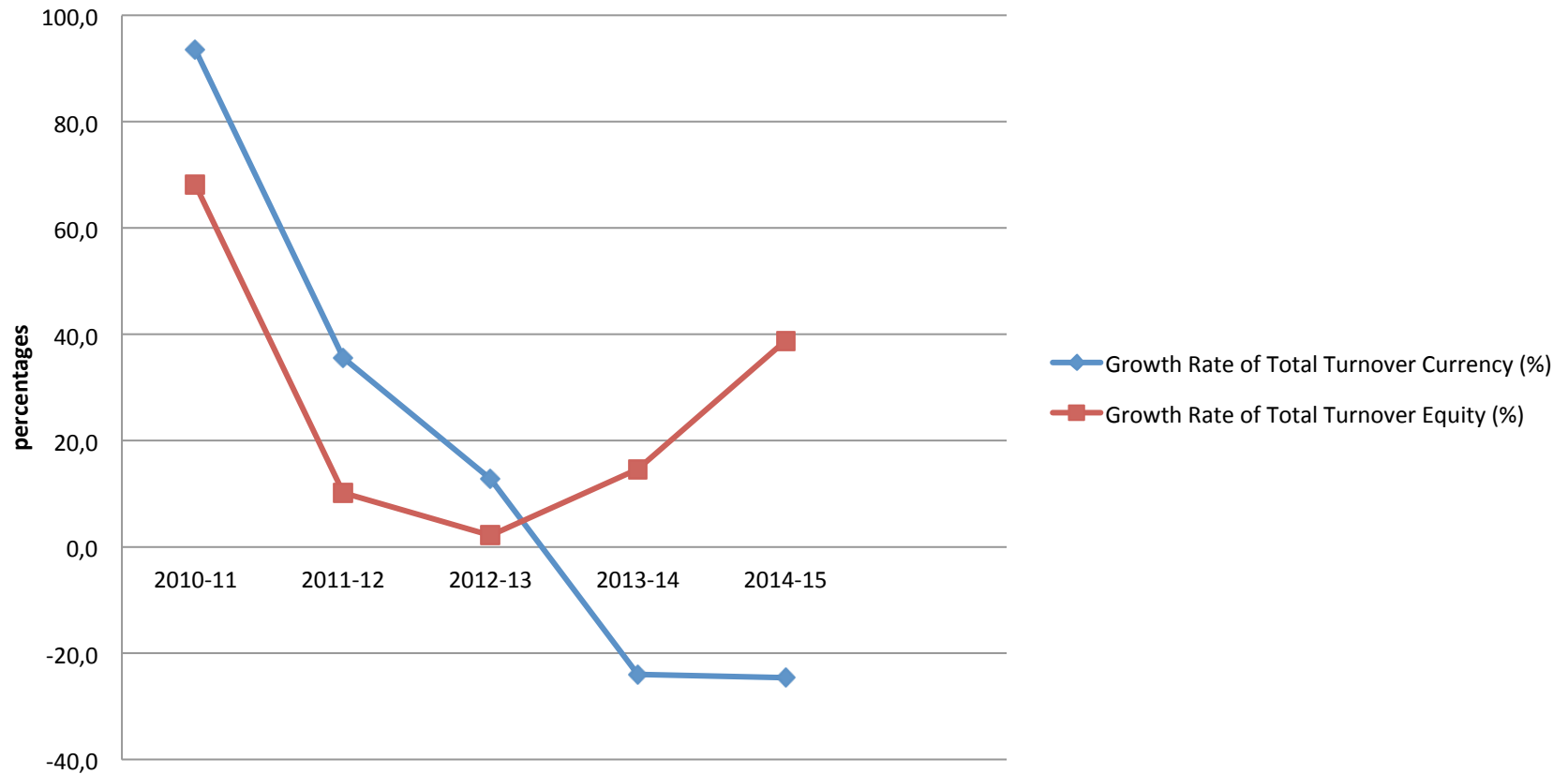


## Average daily turnover for derivatives



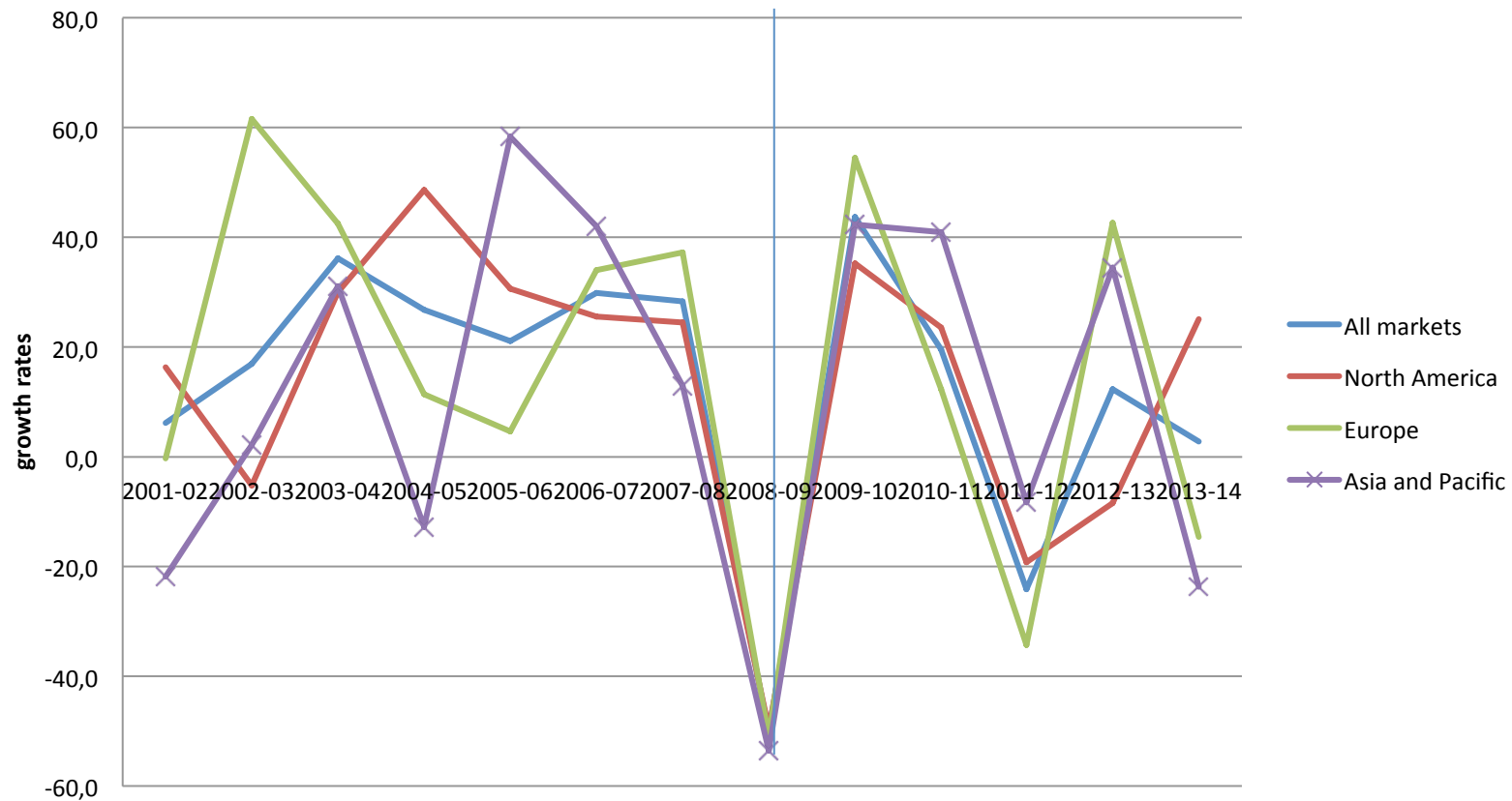
# Derivative turnover: growth rates

Growth rates of derivative turnovers



# Growth rates of derivative turnovers (GLOBAL): source-BIS Quarterly Review March 2015

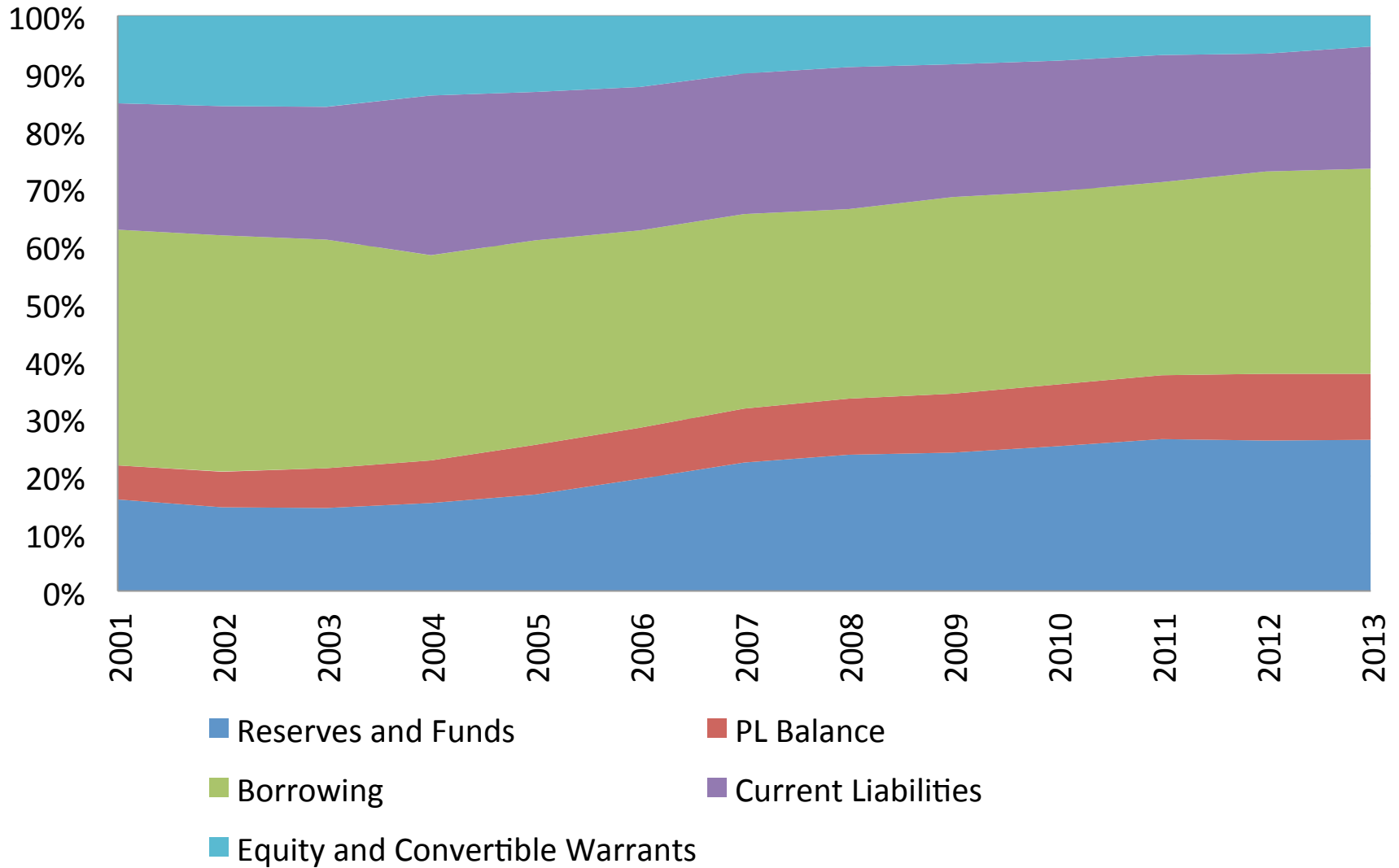
## Turnovers of derivatives



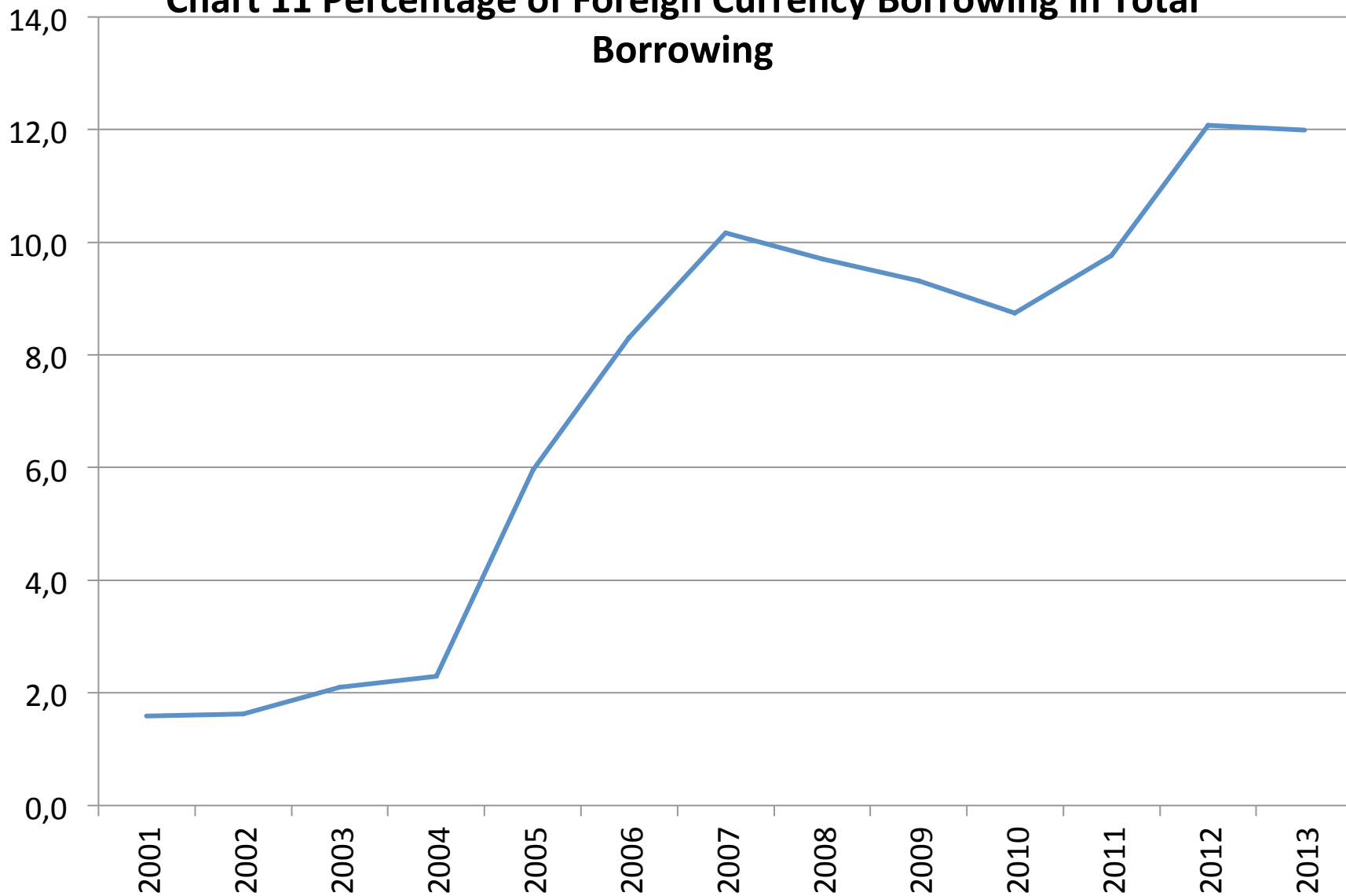
# Growth rates of derivative turnovers (GLOBAL)

- Asia and Pacific displays consistent tendencies for greater degree of volatility as well as amplitude of turnovers, especially since 2005-06, as measured by yoy growth rates.
- All three regions hit by the 2008 crisis when derivative trading was at the lowest growth rate. Recovery by 2009-10 followed by further fluctuations.

# Chart 10 Shares of Various Components in Total Liabilities



**Chart 11 Percentage of Foreign Currency Borrowing in Total  
Borrowing**





# Shares of Various Components in Total Liabilities

- Borrowing used to meet other liabilities... a case of ponzi finance.
- Foreign currency provide a major part of borrowing creating potential mis-match problems

# Conclusion

- Corporates under financialisation prefer short-term financial assets (as opposed to long-term physical investments ).
- Above core of an explanation for industrial stagnation in terms of the trade-off between growth and profitability under financialisation, as mentioned in the literature for the advanced economies.
- For India corporates seem to follow a path of short-termism in the face of uncertainty in de-regulated financial markets with a search for quick returns in the high-risk short-term assets – a deterrent to physical investments.
- Above matched by low growth rates in gross assets as well as profits on them. Does this not mean that the short-term financial assets had less capacity to instill further growth in assets?

# Conclusion(contd)

- Borrowings, domestic and external, along with use of the company-level reserves and funds major source of their funds. Failure of the primary stock market to provide resources via IPO offers.
- Borrowings, as above used to provide resources to meet the current liabilities which include dividends, interest payments etc to be met in each period. Tendencies as above to lean on the financial sector , with borrowings to meet other liabilities generates a Minsky type of Ponzi finance mode which is inherently unstable. The problem is further compounded by external borrowings which adds to the related liabilities in foreign exchange. It thus is a problem not only with the continuing of borrowings to meet charges on past borrowings but also one of a mismatch of currencies in meeting debt obligations.

# Conclusion (cont)

- Indian economy is thus getting exposed to problems which, in addition to the on-going stagnation in the real economy, has been conditioned by the on-going pattern of corporate finance under financialisation, with extensive borrowings to meet the current dues generating seeds of potential instability in the economy as under Ponzi finance.
- Discounting the relatively high levels of financial activity with speculation in stock markets, currency trading, commodity markets and real estates, one notices the sources of instability. Clubbed with a stagnating real sector and the visible disinclination on part of corporates to invest in physical assets therein, Indian economy can not expect a turnaround in absence of an overhaul of policies in the interest of the real economy.