Impact Factor – 6.261 **ISSN – 2348-7143**

INTERNATIONAL RESEARCH FELLOWS ASSOCIATION'S

RESEARCH JOURNEY

International E-Research Journal

PEER REFREED & INDEXED JOURNAL

May-2019 Special Issue – 189

Thoughts, Ideologies and Public Policies

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ISSN : 2348-7143
May-2019

The Policy of Financial Liberalization and Sustainable Economy : A Case Study of India

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Abstract:

Financial liberalization can be considered as a process incorporating the liberalization of the capital and financial account and also elements such as less or different supervision and regulation of the banking sector and often liberalization of the foreign exchange rate regime. Thus, financial liberalization means changes in laws and regulation, leading to greater financial integration, i.e. situation where country's financial system is well integrated in the world financial system. The net impact of financial liberalization on poverty depends upon the initial economic conditions in an economy, the sequencing of financial liberalization, the macroeconomic stability, macroeconomic policies and the quality of domestic institutions, human capital and the composition of capital flows, etc. Economic and social conditions specific to the developing countries do affect the relation between financial liberalization and poverty. Though the policy of financial liberalization does not affect poverty directly, there are remote linkages between both. Financial liberalization may affect poverty positively as well as negatively. Financial liberalization-led-financial integration may reduce poverty through higher economic growth, domestic financial sector development, access to the foreign capital, access to advanced technology, removal of domestic credit constraints, employment generation, smoothing out of consumption and output volatility. Financial liberalization may have some negative effects on poverty through concentration of credit, increased volatilities; income and wealth inequalities, lower social expenditure, and sometimes financial crises. The paper makes an attempt to analyze the impact of financial liberalization on poverty.

Keywords: Financial Integration, Financial Liberalization, Poverty, Multidimentional, Sustainable Growth,

Introduction:

Sustainable Economic Growth has assumed immense importance nowadays. Not only higher economic growth but socially sustainable growth is the aim of every economy. Sustainable economy implies that economic growth is socially sustainable i.e. economic growth is reaching to the poorest of the poor. Building inclusive society is one of the objectives of policies for economic growth. Poverty is an important concern when we talk about economically sustainable society. The presence of poverty and inequality make economic growth unsustainable. Poverty hampers GDP growth rate; affects consumption adversely. It pulls down the aggregate demand, savings, investment and income levels gradually. Thus higher level of economic growth may not be sustainable in the presence of poverty. Once the vicious circle of poverty sets in; economy continues to remain poor making economic growth unsustainable.

Financial liberalization can be considered as a process incorporating the liberalization of the capital and financial account and also elements such as less or different supervision and regulation of the banking sector and often liberalization of the foreign exchange rate regime.

ISSN : 2348-7143
May-2019

Thus, financial liberalization means changes in laws and regulation, leading to greater financial integration, i.e. situation where country's financial system is well integrated in the world financial system.

Poverty is a multidimensional concept having lots of measures and complexities in its measurement. In the present study, Poverty will be considered as absolute poverty. Absolute poverty is defined in reference to a poverty line that has a fixed purchasing power determined so as to cover basic needs.

Though the policy of financial liberalization does not affect poverty directly, there are remote linkages between both. Financial liberalization may affect poverty positively as well as negatively. Financial liberalization-led-financial integration may reduce poverty through higher economic growth, domestic financial sector development, access to the foreign capital, access to advanced technology, removal of domestic credit constraints, employment generation, smoothing out of consumption and output volatility. Financial liberalization may have some negative effects on poverty through concentration of credit, increased volatilities; income and wealth inequalities, lower social expenditure, and sometimes financial crises.

The net impact of financial liberalization on poverty depends upon the initial economic conditions in an economy, the sequencing of financial liberalization, the macroeconomic stability, macroeconomic policies and the quality of domestic institutions, human capital and the composition of capital flows, etc. Economic and social conditions specific to the developing countries do affect the relation between financial liberalization and poverty.

Background

India's financial integration, initiated in the early 1990s and financial sector reforms accompanying it were expected to enhance economic growth. And, it was hoped that this accelerated economic growth would bring more rapid poverty reduction.

The financial integration in India has contributed to higher foreign investment flows, accelerated growth, piling foreign exchange reserves. But, is this growth economically sustainable? Or can one call this growth pro-poor? Has this financial integration-led growth served the welfare objective of poverty reduction and become economically sustainable?

According to the World Development Indicators, in 2009, 362 million people were below national poverty line in India; in 2011, this figure decreased to 273 million people. In terms of the international poverty line of USD 1.90 per day (measured at 2011 purchasing power parity exchange rates), there were 378.3 million poor people in India in a year 2009; this figure has decreased to 259.5 in 2011.

The NSSO data shows that, in the post-reform period, poverty is declining as headcount ratio has decreased from 38.9% in 1987-88 to 36 % in 1993-94, to 26.1% in 1999-2000, to 27.5 in 2004-05 and to 29.8 % in 2009-10[47].

The paper makes an attempt to analyze the impact of financial liberalization on poverty. The paper also aims to analyze the economic sustainability of the policy of financial

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[47] The Head Count Ratios for the years 1987-88, 1993-94, 1999-2000 and 2004-05 are taken from the Planning commission's Official estimates; i.e. Lakadawala Committee estimates. The Head Cont Ratio for 2009-10 has been taken from the Tendulkar committee estimates. According to the Tendulkar committee report, both the estimates are not comparable.

liberalization; to analyze the links between financial liberalization-led-financial integration and poverty; and the ways in which the policy of financial liberalization can be made pro-poor.

Hypothesis:

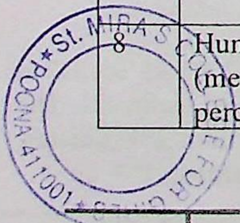
Financial Liberalization-led-financial integration affects poverty. i.e. FDI/GDP affects HCR (Head Count Ratio).

Data Analysis:

In a regression pertaining to the above hypothesis, poverty is the dependent variable and the explanatory variables are - the level of growth, the financial integration, the trade integration, the financial deepening, the inflation, the human capital and the role of the government.

The present study is totally based on the secondary data i.e. basically time series. The data has been compiled for the period 1980 – 2012 from the following sources.

Sr. No.	Variable	Indicator	Source
1	Poverty (measured in percentage)	Percentage of people below Poverty Line/ Head Count ratio i.e. $HCRT_CAGR_t$	'Handbook of Statistics on Indian Economy': The Reserve Bank of India
2	Growth (measured in Rupees)	Per Capita Net National Product at factor cost i.e. $PCNNP_FC_t$	'Handbook of Statistics on Indian Economy': The Reserve Bank of India
3	Financial Integration (measured in percentage)	FDI flows as a percent of GCF i.e. $FDI_PER_GCF_t$	World Development Indicators': The World Bank
4	Trade Integration (it is a Ratio of Exports[measured in billions of Rupees] plus Imports [measured in billions of Rupees] divided by GDP [measured in Rupees at constant prices])	Exports + Imports / GDP i.e. $EXP_IMP_GDP_t$	'Handbook of Statistics on Indian Economy': The Reserve Bank of India & 'World Development Indicators': The World Bank
5	Financial Deepeing (measured in percentage)	M2 as a per cent of GDP i.e. $M2_GDP_t$	'World Development Indicators': The World Bank
6	Inflation (measured in annual percentage change)	Consumer Price Index i.e. CPI_t	'World Development Indicators': The World Bank
7	Role of the Government (measured in Billion Rupees)	Combined Social Expenditure of the centre and the states i.e. $COMB_SOC_EXPND_t$	'Handbook of Statistics on Indian Economy': The Reserve Bank of India
8	Human Capital (measured in percentage)	Youth Literacy Rate i.e. $YLTR_CAGR_t$	'World Development Indicators': The World Bank



'RESEARCH JOURNEY' International E- Research Journal | ISSN : 2348-7143
Impact Factor - (SJIF) – 6.261, (CIF) - 3.452(2015), (GIF)–0.676 (2013)
Special Issue 189- Thoughts, Ideologies and Public Policies | May-2019
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Time series data may encounter the problems of non-stationarity, multicollinearity and / or autocorrelation. The data on the variables given in the appendix is exhibiting increasing trend in general indicating the presence of non-stationarity i.e. varying mean or variance or both. Regression of the non-stationary variables may result into spurious relationship between the variables. Thus the variables in the regression are tested for the stationarity using unit root test.

Unit Root Test Result:

Augmented Dickey Fuller test[48] was chosen to test the stationarity of the series. Augmented Dickey Fuller test with intercept, with trend and intercept, without intercept were performed on all the variables with a null hypothesis that the series has a unit root; i.e. the series is non-stationary. If p value of the test is less than 0.05, then null hypothesis stands rejected and vice versa. The following table shows the result.

The following are the p values and the result of the ADF test of all the variables.

The

Type of Test → / Variables ↓	ADF with intercept and with trend	ADF with intercept and with no trend	ADF with no intercept and no trend	Result
$HCRTcagr_t$	0.1534	0.8316	0.0000	Has a Unit Root.
$PCNNPfc_t$	0.9999	1.0000	0.9986	Has a Unit Root.
$FDI_PER_GCF_t$	0.0301	0.4152	0.3182	Has a Unit Root.
$EXP_IMP_GDP_t$	1.0000	1.0000	0.9999	Has a Unit Root.
CPI_t	0.0460	0.0113	0.1966	Has a Unit Root.
$EMPRATIO_t$	0.0141	0.8011	0.0001	Has a Unit Root.
$YOUTHLIT_t$	0.7191	0.9726	1.0000	Has a Unit Root.
$COMSOCEXPND_t$	1.0000	0.9992	0.9554	Has a Unit Root.
$M2/GDP_t$	0.7490	0.9487	1.0000	Has a Unit Root.

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Table clearly shows that all the variables have unit root or they are non-stationary in nature. To transform non-stationary time series into stationary series, all the non stationary time series are transformed into logs and then first differences have been taken thereof[49]. Again the transformed time series are tested for the stationarity.

[48]Gujarati D.N. (2004); 'Basic Econometrics'; McGraw-Hill Companies; fourth edition.

[49]This kind of transformation can be found in research papers – i) Gaurav Datt and Martin Ravallion (2011) "**Has India's Economic Growth Become More Pro-Poor in the Wake of Economic Reforms?**"; The World Bank Economic Review, Vol. 25, No. 2, pp. 157–189; and ii) Aremo, Adeleke Gabriel and Aiyegbusi, Oluwole Oladipo(2011), "**Can Globalisation Induce**

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Special Issue 189- Thoughts, Ideologies and Public Policies
UGC Approved Journal
ISSN : 2348-7143
May-2019

Unit Root Test of the Transformed variables:

The Augmented Dickey Fuller test with intercept, with trend and intercept, without intercept are performed on all the transformed variables.

Type of Test → / Variables ↓	ADF with intercept and with trend	ADF with intercept and with no trend	ADF with no intercept and no trend	Result
$DLOG_HCRTCAGR_t$	0.0049	0.0014	0.0097	Doesn't have unit root.
$DLOG_PCNNPFC_t$	0.0007	0.0028	0.3356	Doesn't have unit root.
$DLOG_FDIPERGCF_t$	0.0002	0.0000	0.0000	Doesn't have unit root.
$DLOG_EXPIMPGDP_t$	0.0007	0.0001	0.4946	Doesn't have unit root.
$DLOG_CPI_t$	0.3904	0.1737	0.0197	Has unit root.
$DLOG_EMPRATIO_t$	0.0000	0.0000	0.0000	Doesn't have unit root.
$DLOG_YLTRCAGR_t$	0.9726	0.7191	1.000	Has unit root.
$DLOG_COMBSOCEXPND_t$	0.0935	0.0236	0.2617	Has unit root.
$DLOG_M2GDP_t$	0.0145	0.0023	0.0063	Doesn't have unit root.

The above table shows that all the variables except inflation, the youth literacy rate and government's expenditure, have become stationary after the transformation.

Regression Analysis

Regression of $DLOG_HCRTCAGR_t$ (Poverty) on Financial Integration Dummy ($DUMMY_t$) and other transformed variables [$DLOG_EXPIMPGDP_t$ (Trade Integration), $DLOG_PCNNPFC_t$(Growth) and $DLOG_M2GDP_t$ (Financial Deepening)].

Purpose: to study the impact of $DUMMY_t$ (Financial Integration Dummy), $DLOG_EXPIMPGDP_t$ (Trade Integration), $DLOG_PCNNPFC_t$ (Growth) and $DLOG_M2GDP_t$ (Financial Deepening) on $DLOG_HCRTCAGR_t$ (Poverty).

Statistical Test: Stepwise Multiple Regression

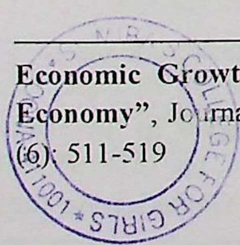
Variables and Measurement:

Dependent Variable - $DLOG_HCRTCAGR_t$

Independent Variables- $DUMMY_t$, $DLOG_EXPIMPGDP_t$, $DLOG_PCNNPFC_t$, $DLOG_M2GDP_t$

The variable $DLOG_COMBSOCEXPND_t$ (Role of the Government) has been excluded from the regression as it was posing a problem of severe multicollinearity. $DLOG_CPI_t$ (Inflation Rate)

Economic Growth In Less Developed Economies? Evidence from Nigeria Small Open Economy", Journal of Emerging Trends in Economics and Management Sciences (JETEMS) 2 (6): 511-519



and DLOG_YLTRCAGR$_t$ (Human Capital) have been excluded for being nonstationary even after transformation.

H_0: DUMMY$_t$ (Financial Integration Dummy), DLOG_EXPIMPGDP$_t$ (Trade Integration), DLOG_PCNNPFC$_t$ (Growth), DLOG_M2GDP$_t$ (Financial Deepening), do not influence DLOG_HCRTCAGR$_t$ (Poverty).

H_1: At least one of the independent variables has an impact on DLOG_HCRTCAGR$_t$ (Poverty).

Level of Significance: $\alpha = 0.05$

Model Summary										
					Change Statistics					Durbin-
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change	Watson
1	.373[a]	.139	.110	.013828065	.139	4.837	1	30	.036	1.864
a. Predictors: (Constant), DLOG_PCNNPFC										
b. Dependent Variable: DLOG_HCRT										

From the above tables, it can be seen that DLOG_PCNNPFC$_t$(Growth) can explain 11.0% of the variance of DLOG_HCRTCAGR$_t$ (Poverty). (Adjusted $R^2 = 0.110$)

From the Durbin-Watson distribution table, it can be seen that the lower and upper critical values of Durbin-Watson (for d 32, 1) are 1.373 and 1.502. The computed value of Durbin-Watson is 1.864. Hence the assumption of independence of error is supported.[50]

ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.001	1	.001	4.837	.036[a]
	Residual	.006	30	.000		
	Total	.007	31			
a. Predictors: (Constant), DLOG_PCNNPFC						
b. Dependent Variable: DLOG_HCRT						

From the ANOVA table it can be seen that the F test is significant [F*(1, 30) = 4.837, P value = 0.036]. Hence it can be concluded that the regression model has predictive ability.

[50] 0----d_L----d_U----2

If 0<computed d<d_L → there is the presence of autocorrelation.

If d_L<computed d<d_U → no decision can be taken regarding the autocorrelation of first order.

If d_U<computed d<2 → there is absence of autocorrelation.

From the coefficient table, it can be seen that $DLOG_PCNNPFC_t$ (Growth) is a significant negative predictor of $DLOG_HCRTCAGR_t$ (Poverty) (b= -0.530, t = -2.199, p = 0.036). Hence if $DLOG_PCNNPFC_t$ (Growth) is increased by 1 unit, $DLOG_HCRTCAGR_t$ (Poverty) will go down by 0.53 units.

From the above discussion the regression equation can be presented as follows.

$DLOG_HCRTCAGR_t = -0.005 - 0.53\ (DLOG_PCNNPFC_t)$

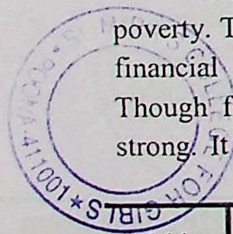
Excluded Variables								
						Collinearity Statistics		
Model		Beta In	t	Sig.	Partial Correlation	Tolerance	VIF	Minimum Tolerance
1	DLOG_M2GDP	.067[a]	.369	.715	.068	.907	1.102	.907
	dlog_expimp_gdp	.055[a]	.316	.755	.059	.987	1.013	.987
	DUMMY = 1,	-.116[a]	-.593	.558	-.109	.765	1.307	.765
a. Predictors in the Model: (Constant), DLOG_PCNNPFC								
b. Dependent Variable: DLOG_HCRT								

Coefficients										
	Unstandardized Coefficients		Standardized Coefficients			Correlations			Collinearity Statistics	
Model	B	Std. Error	Beta	t	Sig.	Zero-order	Partial	Part	Tolerance	VIF
(Constant)	-.005	.005		-1.059	.298					
DLOG_PCNNPFC	-.530	.241	-.373	-2.199	.036	-.373	-.373	-.373	1.000	1.000
a. Dependent Variable: DLOG_HCRT										

$DUMMY_t$ is the key independent variable in the model. The step regression method has excluded $DUMMY_t$ (Financial Integration Dummy), $DLOG_M2GDP_t$ (Financial Deepening) and $DLOG_EXPIMPGDP_t$ (Trade Integration) from the model for being insignificant predictors of $DLOG_HCRTCAGR_t$ (Poverty).

Findings and Recommendations:

The regression analysis excludes financial integration for being insignificant predictor of poverty. Thus it can be said that the links between financial integration and poverty like growth, financial deepening, inequalities, employment, etc. have important mediating role to play. Though financial integration enhances growth, the relationship has not been observed to be strong. It can be concluded that the growth has bypassed many of India's poor. Insignificant



relationship between growth and poverty may be explained with declining employment ratio. The fact that financial liberalization-led-growth has not touched upon the sectors related to the poor like an unorganized sector, agricultural sector, etc. cannot be ignored. These sectors have remained excluded from the financial liberalization-led-growth process and failed to reduce poverty. Thus, the financial integration and financial integration-led-growth cannot reduce poverty automatically and hence, the role of the government in poverty eradication gains importance. There is a need for the role as mediator to make growth more pro-poor through welfare policies. Besides, financial deepening and employment ratio as strong links between financial integration and poverty also have not proved to be significant in the present analysis.

It can be concluded from the findings of the study that financial integration is not meant for poverty eradication, unless and until the policy of financial liberalization is introduced, designed and driven especially to benefit poor. There is a need for a well defined policy on financial liberalization specially to benefit poor to help towards poverty eradication

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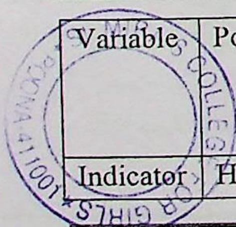
Appendix 1

Variables in the Regression (Poverty regressed on financial integration & other variables) pertaining to the Hypothesis:

Variable	Poverty	Growth	Financial Integration	Trade Integration	Financial Deepening	Inflation	Role of The Government
Indicator	Head Count Ratio	Per Cap NNP at factor cost in period t	FDI Inflows as a per cent of Gross Capital Formation Ratio	X+M/GDP	M2 as a % of GDP	CPI	Combined Social Expenditure
Specifications	calculated with CAGR method	(□) At Constant Prices Base Year 1999-2000; For 2009 and 10 base year is 2004-05.	Calculated	calculated : Exports and Imports in Billion (□); source RBI; GDP in (□); source	(%)	Annual % change	billion (□) Calculated
Source/Year	RBI	RBI	World Bank	World Bank	World Bank	World Bank	RBI
1980	48.28	10712	0.23	0.02223	33.87	11.37	76.09
1981	47.32	11091	0.21	0.02332	33.86	13.12	89.01
1982	46.37	11089	0.16	0.02430	35.48	7.89	108.61
1983	44.5	11742	0.01	0.02694	35.61	11.87	124.77
1984	43.17	11889	0.04	0.02728	37.50	8.32	145.64
1985	41.87	12095	0.19	0.02742	38.85	5.56	160.36
1986	40.61	12328	0.20	0.02788	40.94	8.73	189.47
1987	38.9	12417	0.33	0.03124	41.90	8.80	217.78
1988	38.51	13418	0.13	0.03643	41.77	9.39	250.79
1989	38.13	13947	0.35	0.04468	42.08	3.26	288.35
1990	37.74	14330	0.29	0.05092	41.46	8.97	332.34



Variable	Poverty	Growth	Financial Integration	Trade Integration	Financial Deepening	Inflation	Role of The Government
Indicator	Head	Per Cap	FDI Inflows	X+M/GD	M2 as a %	CPI	Combined

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	Count Ratio	NNP at factor cost in period t	as a per cent of Gross Capital Formation Ratio	P	of GDP		Social Expenditure
1985	41.87	12095	0.19	0.02742	38.85	5.56	160.36
1986	40.61	12328	0.20	0.02788	40.94	8.73	189.47
1987	38.9	12417	0.33	0.03124	41.90	8.80	217.78
1988	38.51	13418	0.13	0.03643	41.77	9.39	250.79
1989	38.13	13947	0.35	0.04468	42.08	3.26	288.35
1990	37.74	14330	0.29	0.05092	41.46	8.97	332.34
1991	37.37	14157	0.12	0.06113	42.67	13.87	372.57
1992	37	14643	0.39	0.07382	43.38	11.79	413.41
1993	36	15181	0.91	0.08600	44.11	6.36	464.27
1994	34.2	15835	1.26	0.09745	45.23	10.21	536.14
1995	32.49	16675	2.24	0.12017	42.80	10.23	641.67
1996	30.87	17714	2.75	0.12574	43.91	8.98	734.76
1997	29.32	18103	3.45	0.13329	46.64	7.16	833.81
1998	27.86	18934	2.61	0.14045	48.06	13.23	1005.46
1999	26.1	20079	1.73	0.15205	50.19	4.67	1177.70
2000	26.36	20418	3.12	0.16972	53.70	4.01	1283.91
2001	26.62	21093	4.33	0.16928	56.74	3.69	1291.20
2002	26.89	21578	4.30	0.19831	61.54	4.39	1410.21
2003	27.16	22985	2.68	0.21719	62.09	3.81	1534.55
2004	27.5	24143	2.46	0.27031	63.52	3.77	1728.11
2005	23.25	26015	2.54	0.31520	64.46	4.25	2039.94
2006	22.29	28067	5.88	0.36479	67.43	6.15	2393.40
2007	21.34	30332	5.36	0.39242	71.00	6.37	2945.84
2008	20.39	31754	9.98	0.50159	75.79	8.35	3806.28
2009	19.44	33901	7.18	0.46114	77.72	10.88	4463.81
2010	18.49	36342	4.39	0.53367	76.08	11.99	5293.98
2011	17.53	38037	5.34	0.67682	76.74	8.86	6237.95
2012	16.58	39168	3.72	0.74108	76.33	9.31	6956.12