HIGHLIGHTS

How financial liberalisation affects household expenditure: evidence from India

The research question addressed by this project is how far do policy changes resulting from financial liberalisation affect household financial behaviour. Using Indian data and experience, this project has tried to relate household consumption patterns to changes in financial policy over the period of financial reform. Changes in financial policy are expected to result in the greater availability of credit as financial controls are relaxed and banking competition is increased. This 'financial deepening' should show up in a higher consumption expenditure in areas where credit is often required, such as durable consumption, education and health.

- Very little research has been undertaken on macro-micro policy interactions. Much of previous research on financial liberalisation has been at the macro level, trying to show a positive connection between financial development indicators and economic growth, or savings growth. Other work has usually involved aggregate data. This research uses the household consumption data collected by India's National Sample Survey Organisation for 11 rounds which straddle the period before and during financial liberalisation (i.e. 1987-2000). The essential methodology is to generate measures of the within-households shifts in distribution of consumption and see how far these are associated with financial development variables. Macro level data has been collected on policy variables and an index of financial development has been constructed to include the major indicators of financial depth, and these correlated with the household measures.

- Findings:

  At the macro level, financial depth did not increase from beginning to end of the period under study:

  - the ratio of private sector credit to GDP was surprisingly the same at the beginning and end of the period with some variation in between; bank credit went into lending to the Government.

  - the liquid liabilities ratio to GDP more surprisingly *fell* towards the end of the period under study.

  At the household level,

  - only the liquid liabilities showed any significant association with household expenditure on health and education.
  - there is a significant association between our measure of durables expenditure and:
    - deposit money to central bank assets,
    - credit to the private sector,
    - stock market capitalisation,
    - the interest rate spread, and
    - the lending rate.

- Policy relevant lessons are:

    - Policies which increase financial depth may have expected effects on credit availability to households and so increase their expenditure on durable goods, while not affecting their expenditure on food;
    - Almost all aspects of financial deepening are associated with increased credit availability to households. This confirms the established view that increased and competitive activity by commercial banks reduces interest rate spread and allows for lower lending rates.
    - Policies which lead to greater credit availability may mean that increased borrowing for consumption reduces saving. This may conflict with other policy objectives, for example, to increase investment shares.

ANNEX

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