IDENTIFICATION OF THE CRITICAL ISSUES IN THE INDIAN FINANCIAL SECTOR BY THE POLICYMAKERS

Dr. Mayank Malviya*, Dr. Prateek Khanna**

*Associate Professor, Department of Business Administration, Shambhunath Institute of Engineering & Technology, Prayagraj, Uttar Pradesh, India;
Orcid id: https://orcid.org/0000-0002-7471-2938

**Associate Professor, Department of Business Administration, Shambhunath Institute of Engineering & Technology, Prayagraj, Uttar Pradesh, India
Orcid id: https://orcid.org/0000-0003-2708-0568

Abstract- The purpose of this paper is to determine how policymakers should answer incidents of financial crisis in India. It finds that in such times policymakers are faced with two critical tasks. These are to identify and appropriately address the problems critical to the crisis and secondly to ensure that the sector reaches a new equilibrium. It finds the primary task to be important given the resource constraints of policymakers and distinguishes it from addressing the causes of the crisis. The paper also suggests that to deal with the secondary task it is important the policymakers understand three fundamental pillars of financial sector stability and development. The importance and precise nature of these tasks are illustrated using evidence from the Indian Financial Crisis, Savings and Loans Crisis. In addition to identify these tasks, the paper proposes policy-making frameworks to deal with each of the identified tasks. These frameworks are developed from a critical reading of the related literature and a study of the cases reviewed.

Key Words: Indian Financial Crisis, Savings, Loan Crisis, Policy-making

I. INTRODUCTION

A financial sector crisis may be loosely defined as a situation that happens when financial sector problems and weaknesses reach very severe levels. It is a problem of concern to policy-makers and broader society because its impact and consequences extend beyond the financial sector. This is the case because the financial sector plays a central role in the economic system, influencing the price and availability of credit and acting as a trustee of the wealth of citizens. At the time of writing, the effects of financial crisis are well illustrated by the sub-prime mortgage crisis in India. A crisis, the extent of which is not yet know, which has already severely affected home ownership, consumer expectations and contributed to expectations of an economic recession.

An important question to this paper is how should policy-makers respond to financial sector distress? This question is asked as to believe that the costs and impact of financial sector problems and weaknesses are often significantly mitigated by good policy-making.

The paper proceeds by giving some background necessary for an understanding of the problems discussed. This includes the principle for policy intervention during financial sector distress. This is followed by an outline of the approach of the thesis and some concluding remarks.

This paper aims to examine the nature of policymaking in the face of financial sector distress. In examining how policy-makers should respond to financial crisis the paper seeks to identify the critical tasks of policy-makers and provide a framework for performing these tasks. The choice of the Indian Financial Crisis, Savings and Loans Crisis is motivated by the different dynamics involved. In these crises the dynamics include the international nature of the Indian crisis, the lengthy nature of the Savings, Loans crisis and differences in broader government ideology. Additionally, the selection of these crises allows a comparison of policy responses in developed and developing countries.

This analysis may also give a sense of the impact of the involvement of international development organizations in the reform process. These cases also serve as good illustrations of key findings of this paper, although this was not the reason for their selection.

Finally, the cyclical nature of financial crisis and its ever increasing costs suggests room for an improved

understanding of financial crisis and therefore the nature of appropriate policy responses.

II. REVIEW LITERATURE

The literature suitable to a study of financial sector reform is fairly extensive. It covers ideas associated with the advantages of the financial sector, the history of financial sector regulation and behavior as well as case studies of financial crises and events. In this paper, the main target will be on the literature associated with the financial sector reform and crisis. In discussing the advantages of financial sector reform attention in the literature is on the link between the financial sector and economic growth.

It begins with the early works of authors such as Bagehot (1978) and Schumpeter (2002) and is extended by scholars such as Goldsmith (1969), Tompson (2000), Chowdhury (2003), Schich (2007), Damodaran (2013, Joshi (2016) and Ozili (2020). It presupposes that since a well developed financial sector improves economic outcomes, financial sector reform to assist this goal is desirable. The literature also makes the connection between financial sector activities and therefore the achievement of social welfare outcomes. The relation between the financial intermediaries and poverty alleviation is discussed with the content of microfinance (Sheahan, 1997; Morduch, 1999, Spencer & Wood, 2005).

However, the institution of reforms is difficult and therefore the literature provides an understanding of this by outlining the history of the financial sector. The discussion of this issue contained in this paper is moved towards the developing nations. This is often done to provide both the present context of the financial sector in developing nations and also to provide a historical perspective for developed nations. This part of the literature provides an understanding of the government involvement and highlights prominent problems related with improper policy prescriptions (McKinnon, 1973; Brownbridge & Kirkpatrick, 2000; Friedman & Click, 2006). It highlights the 'political economy' of financial sector reform and therefore the manner in which political inertia affects reform efforts. Financial sector need to be more diversified and ease related to capital flows. However the recent decisions by the policymakers express disinclination to interfere in the working of the financial sector. Policymakers restrict the registered FII's to issue the P-note to the overseas investors without registering it with the SEBI. Thus the role of policymakers is more important to manage the critical factors of the financial market (Schich, 2007).

The literature is also concerned with the environment where the reforms in the financial sector take place. Particularly important is the legal environment and issues related to the rule of law, contract law and the laws for dealing with bankruptcy and insolvency (Osborne, 2001; Guide & Patillo, 2006).

It also discusses the impact of the macroeconomic environment on financial sector reform with issues such as foreign exchange policy, international trade and current account deficits of particular relevance (Berg, 1999). Another relevant environmental factor is recognition of international factors within the performance of the financial sector. It is clear from a reading of the literature that issues like international capital flows, international standards of regulation and international contagion are matters of importance.

In addition to the points outlined above the literature covers criticisms of the financial sector reform agenda. These relate to a perception that reforms have failed to improve economic outcomes, particularly based on the nations in developing phase (Osborne, 2001; Brownbridge & Kirkpatrick, 2000). A second source of criticism is that the role of international development organizations in promoting reform.

Authors like Schoenholtz (1987), Officer (1990) and Bird (1996) outline reasons why the reforms suggest by these organizations have failed to generate the desired outcomes.

Further to this, a reading of the literature indicates the existence of a view that financial sector reform has sometimes been a means to advance economic ideology instead of improve operations of the financial sector.

A large part of the literature is related with the failings of the financial sector. This part of the literature puts forward the ideas of ethical hazard and adverse selection as root causes of financial sector (Caprio & Klingbiel, 1996; Krugman, 1998; Berg, 199, Hahm, 2005). It is in this part of the literature that discussions of financial crises are situated. The approach taken in the literature is to find cases of financial crisis, identify the causes and evaluate the responses to the crisis. A prominent work in this area is that of Caprio & Klingbiel (1996) who carry out a global survey of financial crises, their causes and the resulting policy responses. Emerging from the literature is the identification of prominent financial sector weaknesses and their social, political and economic impact (Brownbridge & Kirkpatrick, 1999; Chowdhury, 2003). A reading of the literature reveals that financial crisis invariably motivate reform, overcoming political and institutional inertia. It is in this segment of the literature that this paper resides. It is the aim of the paper to determine what policy-makers

should do when faced with financial sector distress and provide a framework for their response.

The review of the literature presented to the criticism highlights the rationale for financial sector development and reforms aimed at an improved financial sector. A first point of criticism lies in the observation that financial sector liberalization can increase economic instability and may not provide the expected benefits (Osborne, 2001; Brownbridge & Kirkpatrick, 1999; Kwon, 2004). This criticism suggests a favoring of greater government controls and policy to regulate the outcomes emerging from the financial sector. Furthermore it is put forward that financial sector reform limits the autonomy of governments and encourages contractionary macroeconomic policy (Osborne, 2001). This criticism arises from evidence that developing countries who have undertaken financial sector reforms continue to experience financial crises (Caprio & Klingbiel, 1996). (Cull, 2001) notes that in a sample of 19 nations subject to World Bank led financial sector reforms only 5 countries could classify programs as successful. This is a view reinforced by the opinion of Osborne (2001) who states that speculative capital flows make financial crises inevitable. He argues that this is particularly true for developing nations about whom relatively higher levels of uncertainty exist. Therefore the only way to avoid these negative consequences is to limit financial sector liberalization and development. A response to this criticism is additionally present in the literature. It is to observe that resulting economic weaknesses are short term phenomena that result from the costs of economic adjustment (Brownbridge & Kirkpatrick, 1999; Kwon, 2004). The literature suggests that this weakness can be offset by the institution of broader economic and social reforms to ease the friction of the transition period (Gupta, McDonald, Schiller, Verhoeven, Bogetic & Schwartz, 1998).

A second criticism of financial sector reforms is leveled at the proponents of financial liberalization in developing countries, such as the Organization for Economic Cooperation and Development and the IMF. Authors such as Schoenholtz (1987) raise concerns that the motives of the IMF and such institutions are not to the benefit of developing nations but instead favor donor nations. This view arises in part from the structure of such institutions in which voting rights are proportional to total funds contributed (Officer, 1990). This leads to the assertion that there is an inherent bias against developing nations (Officer, 1990). This view is also bolstered by the evidence that benefits touted in reform programs have often failed to materialize in developing nations (Galli, 1990; Bird, 1996). It is also alleged that these reforms have failed to adequately consider the needs of the poor (McKinnon, 1973). Instead the reforms are said to be narrow and to have ignored important development issues such as gender equity and their influence on economic outcomes (Nyamu – Musembi, 1996). The global financial crisis from 2007 to 2010 affected the trade and investment globally. In the year 2009 the first phase of global financial crisis can't affect the Indian banking sector but in the second phase of global financial crisis India had affected in three different channels i.e. financial markets, trade flows and exchange rates (Kumar & Vashisht, 2009). This was universally affecting the world trading system as well as the Indian Financial market. Due to this crisis various critical issues like unemployment, fall in export prices, etc. was generated which globally failed the policies already implemented and also affect the developing countries (Escudero, 2009; Shelburne, 2010). In 2013 a research that identified three basic questions belongs to crisis are main factors of financial crisis, major types of financial crisis and the real sectors of financial crisis. Main factors include the credit and asset markets declined as there is a need of development. Major types include currency crisis, sudden stop crisis, debt crisis and banking crisis which are also required to be improved. In the last question the real crisis include changes in consumption, investment and industrial production. Thus these entire crises required some modifications by the policy-makers which can help to sort out the different critical issues if the financial sector (Claessens & Kose, 2013). In the year 2017 it was observed that inadequate rules and regulations provided by U.S. financial market regulators can adversely affect the global financial sector and in turn generated the various critical aspects for the policy-makers in the Indian financial sector (Grosse, 2017).

Financial system plays a vital role for the development of the country and due to that there is a regular requirement of financial reforms by the policymakers. Due to regular financial sector reforms it is easier to occur larger and productive investment as well as reduce the bad loans (Joshi, 2016). For the reform of the financial sector there is a need of financial inclusion which reduces the gap between rich and poor. It helps to enable the flow of money in the economy and support the policymakers to take best decisions for the upgradation of Indian Financial Sector (Damodaran, 2013). For the current development of the financial system the researcher identifies some emerging issues belongs to the financial sector i.e. the financial inclusion and its controversial policies. The researcher targeted on how financial inclusion can generate

the systematic risk and affects the financial sector working which in turn change the decisions of the policymakers (Ozili, 2020). In the current time period i.e. during COVID-19 pandemic financial market drastically changes all over the world. Different critical issues generate that adversely affect the policy and the decisions of the policy-makers. There are lots of uncertainties generated in the global financial market which in turn creates various unpredictable situations for the upcoming future (Zhang et. al., 2020). Pandemic adversely affect the global financial system. The financial market of less-free countries like India is more affected as the number of COVID cases increases. Due to lots of changes in the investment decisions by the investors, the financial market become unpredictable in the current situation. This now generates different critical situations for the policy-makers to take decisions for the current and future time period (Erdem, 2020).

III. CRITICAL ISSUES OF INDIAN FINANCIAL SECTOR

Economic growth and relatively high domestic rates of interest led to large capital inflows, most notably from banks. These large capital inflows were then intermediated by local financial institutions and it is here that the origins of the crisis lie. The process of intermediation was characterized by lending practices such as insider lending and a concentration of lending in areas such as real estate and government endorsed borrowers. Additionally, financial intermediaries didn't directly handle all their maturity and rate of exchange risk. In the case of maturity risk, strong economic performance was generating high returns that made international lenders willing to 'roll over' short term loans. This provides domestic institutions to depend heavily on short term borrowings to invest in long term projects. It is noted here that the use of short term borrowing to finance long term investment is not inherently bad. However, it must be recognized that it is a borrowing source that requires a high degree of institution and market liquidity. It is also a markedly more risky activity when borrowings are in a foreign currency that may fluctuate in value. In the case of Indian economic system, interest rate risk was not managed entirely by financial institutions as they operated under a fixed exchange rate system. In such a system the government controls currency supply and demand to eliminate almost all fluctuations in currency value. This activity creates a situation in which very little risk is associated with foreign currency transactions, leading banks to refrain from managing the currency risk on their foreign borrowing.

At the time of demonetization there was a collapse in the real estate market. It was the case that the easy access to credit had led to rapid growth in commercial real estate investment and prices. This had led to the accumulation of a surplus of up to 6 years worth of commercial real estate development. This abundance of supply led to a sharp reduction in occupancy rates and a depression in real estate rents and prices. The downturn in the real estate market had a ripple effect throughout the economy. It led to an increase in borrower defaults to banks who had concentrated lending in commercial real estate concerns. This led to a reduced desire to invest in the Indian economy and correspondingly a reduced desire to hold the rupee. However, under the prevailing system of exchange rate controls the government supported the high value of the rupee which triggered speculative attacks on its value in currency markets. In a failed attempt to prop up its currency Indian government spent ₹330 crore of its foreign currency reserves but within a year the rupee had lost 60% of its value. This pursuit at rate of exchange control increased speculative activity and reduced investor confidence. The weakening currency and investor confidence combined with the losses suffered by foreign lenders to domestic banks led to capital flight. The weakening of the rupee meant that exports from India began to become relatively cheaper than those from other regional exporters. A situation likely worsened by the fact that the government also maintained strict currency controls. However, there is scant evidence that these proved to be significant economic factors. Nevertheless, the loss of investor confidence represented by the severe depreciation of the rupee proved significant for other countries in the region. Investors fearing similar losses in neighboring countries began to withdraw their funds and fueled currency speculation that led to currency crashes. It was the case that the currency lost close to half of its value in a matter of months. In understanding this series of events it helps to note that the same groups of foreign lenders were prominent in each affected nation. This meant that losses in any country affected their ability and willingness to weather economic difficulties in other countries.

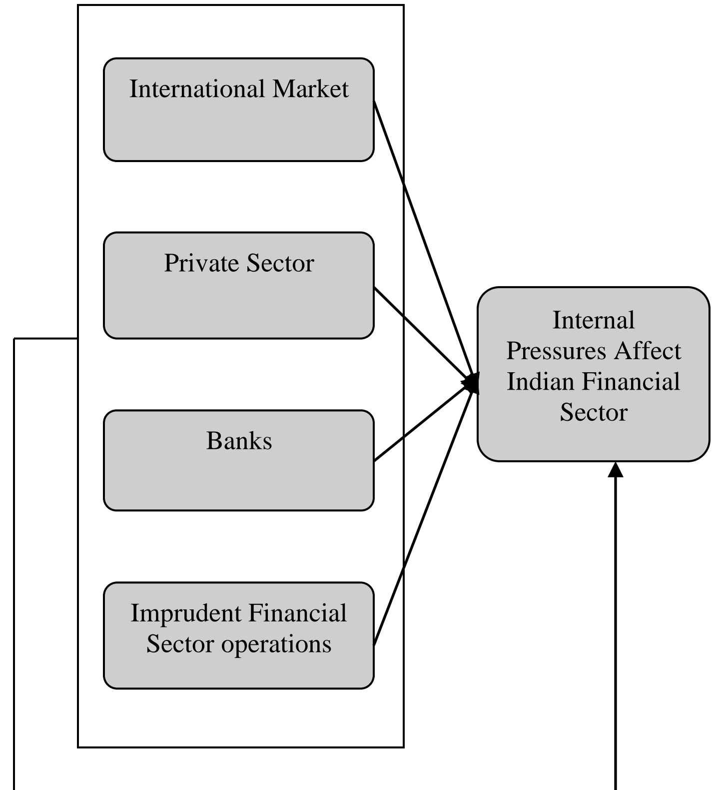
The loss of investor confidence led to capital flight in excess of ₹500 crore within a period of less than a year. Estimates suggest that net private inflows declined from over ₹200 crore in 2018 to ₹60.4 crore in 2019 to -₹12 crore at the resolution of the crisis till March, 2020. It bears remembering that the vast majority of these cash inflows were from private creditors to domestic financial institutions and not from aid agencies or public funding.

Furthermore, only about 20% of total capital inflows were equity investments. This indicates that they have funds that haven't the part of binding long term political or economic agreements. This suggests that investors were able to and inclined to remove their funds at the earliest opportunity. Additionally crippled by a high number of non performing loans, several financial institutions within the region were compelled to close.

IV. ANALYSIS OF CAUSES

A prominent part of the literature on the Indian Financial Crisis is a discussion of why it happened. This segment of the literature invariably recognizes the crisis as the result of internal pressures and not external shocks. This is to say that factors such as changes in international markets that might have affected the price and costs of exports were not responsible for the crisis. A second point of agreement in the literature is that these internal pressures originated from the private sector rather than issues with the government. This is to say that the affected nations preserved sound macroeconomic fundamentals with no concerns over issues such as sovereign debt and fiscal impropriety. A final point of uniformity in the literature is found in the crisis was centered on the financial sector. When crisis is not caused by macroeconomic factors it is likely the result of a run on institutions or moral hazard and information asymmetry in the financial sector. A summary of the cause of the crisis as presented in the literature is that it was the result of imprudent financial sector operations fueled by imprudent government dealings with the financial sector. It is put forward that the crisis was the fruit of credit risk in the financial sector that resulted from poor regulation in nations with a preponderance of political rather than commercial lending criteria. This credit risk was characterized by a concentration of lending among a small group of borrowers while relying on narrow profit margins. These activities were fueled by inadequate regulatory supervision and improper institution relationships with borrowers and the government. Government ownership of banks, guarantees against insolvency and improper responses to the large capital inflows and credit expansion are considered important explanatory factors in the Indian financial crisis. This view of the cause of the crisis is appealing because it provides a link between the state of the financial sector and the resulting problems. This explanation also accommodates the role of the regulatory environment of the financial sector in the occurrence of a crisis. Therefore, a view of the cause of the financial sector problems focused on imprudent lending, institutional weaknesses and government imprudence appears most appropriate. This is a view of the financial crisis that is rooted in the moral hazards of the system, its design and its operation. This would suggest that the critical issues facing policymakers was how to adjust the financial system to remove sources of moral hazard. The different internal pressures affect the financial pressure discussed in Figure-1.

Figure-1: Conceptual Framework related to internal pressure which affect the Indian Financial Sector



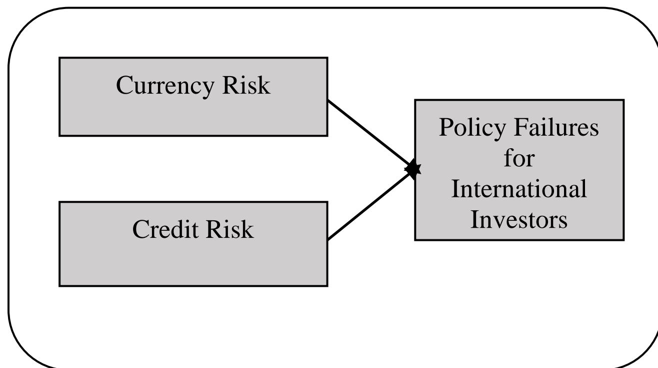
Source: The authors

V. WHAT WAS THE POLICY FAILURE?

It is the view of this paper that the ineffectiveness of policy making lay in that policy did not effectively and appropriately address the issues of currency risk and credit risk for international investors. More specifically, this paper finds error in the continued support of fixed exchange rate regimes by the affected nations. The discussion presented in previous sections suggests that the cause of the crisis was a run on domestic banks by foreign investors. It is the position of this paper that policy to manage currency risk could only have been effective if tailored in a manner appropriate for foreign investors. Instead, government policy aimed to manage currency risk for the entire nation. In so doing they attracted the attention of speculative international capital which far exceeds the foreign reserves of the nation. Importantly, given the size

of international currency markets limited government reserves were unable to eliminate currency risk for their entire nation. The protracted exchange rate uncertainty and government action only served to increase the currency risk faced by investors and deepen the problems in the financial sector. The discussion of root causes also identified credit risk as an important factor. It was the case that currency depreciation meant that international investors faced increased credit risk. This was the case because even though domestic banks were assisted by policy measures such as re-capitalization and deposit insurance the weakened currencies made it hard for them to repay international investors. Figure-2 belongs to the relation between the different risks which can fail the policies for International Investors.

Figure-2: Conceptual Framework related to risk and policy failure for International Investors



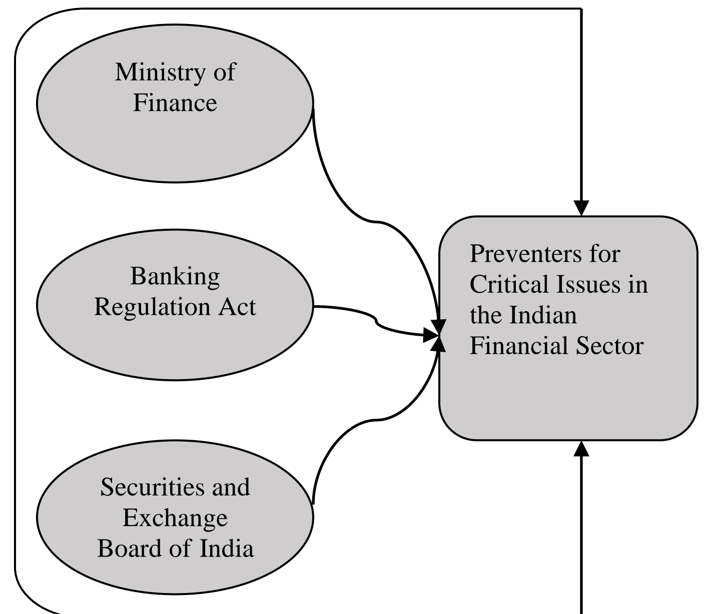
Source: The authors

VI. POLICY RESPONSES

This section sets out to examine the nature of policy responses to financial sector problems in the affected nations. It does not focus on analyzing the efficacy of policy but tries to determine if the policies enacted were appropriate given the underlying causes. The discussion of causes presented above suggests that the crisis was caused by a run on banks by international investors. Investors who faced credit risk as a result of weaknesses in the financial sector and faced currency risk due to a weakening currency. It is these two issues that policy responses should have sought to address.

The policy-making of the affected nations is not an issue of deep coverage in the literature. In the case of the Indian government, an extensive policy response was implemented. It is reported by the Ministry of Finance that emergency decrees were put in place to facilitate financial sector restructuring. These included the power of banking regulators to compel the financial institutions to write down capital, raise new capital and change its executives to government appointees. The primary purpose of these laws was to protect the public interest from the large losses being experienced. There were also amendments to the Banking Regulation Act to reaffirm the government's commitment to guarantee depositor and creditor funds through the Financial Institutions Development Fund. It is also required that in all the financial sectors there must be an involvement of Securities and Exchange Board of India (SEBI) to take decisions and manage the critical issues in the Indian Financial Sector. Figure-3 defines the preventers of the Indian financial sector.

Figure-3: Final Validated Framework related to preventers of critical issues in the Indian Financial Sector



Source: The authors

VII. CONCLUSION

It is believed that the work conducted in this paper is relevant, significant and timely. Global economic forces, the rapid pace of technology and innovation present policymakers with a financial sector in constant change. This places an ever increasing set of demands for understanding, competency and capacity on policymakers. Recent events in the United States exemplify the complexity of the issues at hand. It is believed that ideas and approaches that to a significant degree can assist the policy-making process. The research presented identifies clear goals for policy-makers and simple approaches for their achievement. The paper does not claim that the

application of its findings will be able to prevent financial sector distress and the resulting hardship. However, it is clear that experiences to date can better equip policymakers to mitigate the economic and social costs and shorten the length of hardship.

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Correspondence Author – Dr. Mayank Malviya, Email address- mayank.joinwith@gmail.com, Contact Number- +91-9795652869.