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Role of Financial Intermediaries in the Economic Development of India

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ABSTRACT

The Indian Economy has accomplished almost seven and half decades of planning and this has been a period in which the economy has achieved varying degrees of success and failure and this has also been an era of experiment which has taught some hard lessons to the policy makers. It is no denying the fact that in the course of the last four decades there has been a constant need to arrange and rearrange priorities between development objectives to adjust to circumstances as they evolved, some of these circumstances reflected policy failure while others were a reflection of Micro-economic inefficiencies and structural imbalances prevailing in the economy. The issue is whether the Indian Economy has shown the much needed resilience in combating both the Exogenous and Endogenous Economic crises as they evolved; Whether the Micro-Economic performance has been sustained to the extent it was desired in view of constantly changing economic environment and also changing priorities between development objectives.

INTRODUCTION

This experience of almost four decades has compelled policy makers to re-evaluate and to give a fresh consideration to ideologies, approaches and methods of organizing production, consumption and exchange in the Indian economy. All these efforts of policy makers have resulted into the process of economic liberalization. The Indian economy has been experiencing the winds of liberalization. Since the early eighties the measures to this effect have been implemented in the areas of trade, taxation and industrial policies. However, it should be noted that these deliberate conscious attempts are more specifically aimed at augmenting the long-term real growth of the economy through improving the resource allocation, strengthening resource mobilization and eliminating structural imbalances in the Indian Economy. Recently there has been resurgence of interest, inspired in large part by the works of Mckinnon and Shaw in the role of money and finance as a means of accelerating economic growth of the developing countries. In fact, Money and Finance as instruments of financial development are crucial to the process of economic growth. The contemporary Macro theory has taken a peculiar stand on the role of the institution of money and the financial system in the economic processes of a market economy. Though it has paid a great deal of attention to the functioning of the money and the financial market and also its implications to the short-run stabilization policies, it had divorced the problems of the economic growth and development from the analysis of the problems of the monetary and financial development of a society. This is probably why the growth models are cast in physical terms and the growth path is shown to be neutral to the changes in the monetary and financial structure. Attempts are recently being made to generalize the theory of economic growth and development and overcome the drawback. Tobin, and other economists have tried to accommodate real money balances in the neo-classical and Keynesian growth models. Gurley and Shaw and others have emphasized the importance of financial intermediaries in the saving-investment process. During the 1960s, the question of how the domestic financial structure (consisting of the whole range of existing financial institutions, financial markets and financial instruments) could contribute to economic growth started to receive some attention. The extent to which financial development-defined as the growth of domestic financial institutions, markets and instruments could improve the process of financial intermediation-became important for raising domestic savings and improving the quantity and quality of investment. Improving financial intermediation was of crucial importance, according to these early contributions, since high savings and more efficient investment would increase the overall growth performance of a country.

It is contended that apart from being an economically efficient system of mobilizing savings to promote efficient capital accumulation, an elaborate financial system enjoys huge external economies in a decentralized economic system. The external economies of the system of finance are mainly of two types. The evolution of a rudimentary financial system is marked by a financial claim, money which by being universally acceptable at a fixed nominal exchange rate for real goods reduces considerably the real costs of conducting exchange and promotes the development of organised commodity markets. It also reduces the risks of economic transactions and makes the cost of information about exchange possibilities cheap. The emergence of money brings huge windfalls of efficiency and welfare in a barter economy and subsequent increases in the supply ofthese instruments keep adding to the overall economic

efficiency ofsociety, though at a slower rate, either by monetization of the hither to non-monetized regions or greater accumulation and use of money instruments by the public.

Second, in a decentralized world without finance, absence of proper conduits to hold savings is a constraint on the intertemporal utility functions of the individuals. The desired time pattern of consumption of the society will probably be skewed for present consumption and against future consumption. The well developed financial system offers the savers a wide array of financial assets which are superior to the physical assets as conducts of saving in terms of risk-return-liquidity characteristics and which can remove the institutional constraints on the intertemporal utility functions and result in a higher proportion ofincome saved.

The neo-liberal view appeared in the early 1970s mainly with the work of Ronald McKinnon. It places the financial constraint discussed by the structuralists at the centre ofthe analysis. 'Financial Repression', caused by monetary mismanagement in the form of excessive growth of the money supply and erroneous selective credit policies, is the major factor contributing to the structural problems, lack of investment, and inflation in TWCs.

The neo-liberal model is essentially an incomplete neo-classical model in disequilibrium. The assumptions are key : The first is that the economy is fragmented, so agents are faced with different prices for factors of production, some factors are at times immobile, and agents have differential access to technology, misallocation of resources is the result, and this misallocation represses accumulation.

The main indicator of financial repression is the prevalence of negative real interest rates (Galbis, p33).Market imperfections mean that factors cannot be treated symmetrically as in orthodox analysis. Instead, the capital market and its special problems is emphasized, the capital market must be improved before other liberalizing policies can be carried out/

The second assumption is that money and real assets are not substitutes but complements in the money demand function (McKinnon, p5).4 Money is an important difference between the neo-liberal and neo-classical models. What is similar in the two is that the price level is determined by the demand for and the supply of nominal money, individuals' expectations about future price movements are influential in determining real cash balances held, and the monetary authorities determine the real return on holding money by controlling the nominal money supply. M, and- the nominal rate of return to holders of money. But the fragmented economy changes the demand for money function. McKinnon's money demand function is based on two assumptions about conditions in TWCs. Due to the lack of organized finance, all economic units are assumed to be confined to self-finance, so that saver's are equivalent to investors and there is no private sector borrowing. The second assumption is that the small size of firm/households makes indivisibilities in investment important. These assumptions mean- that cash balances are the only financial instrument available that can be accumulated. Also, the restraint on external borrowing means that individuals cannot make the 'best' investments embodying the 'best' technology. Rates of return on physical capital are thus dispersed. It is the imperfection of capital markets which causes the misallocation of resources, the use of inappropriate technology, and consequently unemployment. Government fiscal policy is assumed not to affect aggregate capital accumulation directly, so the only way public policy can affect accumulation is through the real return on holding money d-p. (McKinnon, pp56-57). The money demand function (which is really the demand for money held in savings accounts since in an inflationary economy the opportunity cost of holding cash would keep it at a minimum) is (M/P)d=f(Y,I/Y,d-p). Real money demand is a function ofincome, The ratio of investment to income (investment demand), and the real return on holding money. All partial derivatives are positive.

A rise in real interest rates should come from two sources : A non-inflationary monetary policy, and the gradual liberalization of financial markets. Removing interest rate ceilings must be gradual to prevent short-run problems of bankruptcy of financial institutions as they pay higher interest rates to depositors while stuck in long term low interest lending arrangements. (A problem pointed out by Mathieson, pp 359-60). As loan portfolio of financial firms change, both real lending and deposit rates can rise.

Theoretical literature

A survey ofthe theoretical literature is needed to find plausible hypotheses to explain the relation between financial development and economic growth. Although others have surveyed this literature recently (see, among others, Fry, 1988;8 Gertler& 1988;9 and Pagano, 1992), The literature on issues of development economics expanded rapidly after World War II. One important issue was the problem of financing economic development (Prebisch, 1950 Nurkse, 1953 and Lewis, 1954). Initially, much attention was paid to the issue on how the accumulated financial resources could be used most efficiently to stimulate economic growth. Less thought was given to how national savings could be ^mobilized and how these savings could be transmitted into efficient Investment. During the 1960s, the question of how the domestic financial structure (consisting of the whole range of existing financial institutions, financial markets and financial instruments) could contribute to economic growth started to receive some attention. The extent to which

financial development could improve the process of financial intermediation, became important for raising domestic savings and improving the quantity and quality ofinvestment.

Role of financial intermediary

Gurley and Shaw (195514, I960 and 1967) explicitly stressed the importance of financial intermediation in the process of economic development. They argued that financial intermediation increases the amount of funds available for investment by providing credit through financial institutions. The more efficiently these institutions execute their credit supply function to finance investment, the higher the economic growth performance of a country. Other authors have expanded on the ideas of Gurley and Shaw, in showing that a more efficient system of financial intermediation contributes to higher mobilization of domestic savings and to a more efficient allocation of financial resources into investment projects (Patrick, 1966; Proter, 1966). These aspects were central in later discussions of the importance of financial development in economic growth, led by McKinnon (1973) and Shaw (1973). Patrick (1966)21 introduced the concepts of demand-following and supply-leading, to describe the nature of the causal relation between financial development and economic growth. He described demand-following as the situation where financial development is a result of developments in the real sector; the demand for financial services from this sector automatically creates financial institutions and instruments. Several authors have tried to find evidence for the direction of causation between financial development and economic growth. Patrick (1966, pp. 176-177)22 suggested that in the early stages of economic development, a supply-leading relation is more likely since a direct stimulus is needed to collect savings to finance investment for growth while, at a later stage, when the financial sector is more developed, the demand-following relation will be more prevalent. He illustrated this point by describing the economic development process and experiences ofJapan during the period between 1868 and 1914 and stated that: “The modem financial system was not only created in advance of Japan’s modern industrialization, but... contributed significantly to the initial spurt” (Patrick, 1966, p. 177; and Patrick, 1967. A more advanced econometric approach was taken by, among others, Gupta (1984)25, Jung (1986)and St. Hill (1992)who tried to find empirical evidence for the direction ofthe causal relation by using the Granger causality test. Gupta found support for the supply-leading hypothesis in a study of 14 developing countries. Both Jung and St. Hill, using data on 56 countries, of which 37 were LDCs, found a moderate support for this hypothesis in LDCs, while the demand-following hypothesis appeared to fit more closely the situation in developed nations.

Financial instruments to mobilize saving

Important ways, though limited by which society can mobilize its savings to accelerate economic growth;

1). Central planning in which a part or whole economy surpluses individual spending units as pre-empted and distributed by the state on predetermined criteria among those *spending* units which need investible resources.

2) The second method is implementing the fiscal policy in which the state appropriates part of the economic surplus of society and invests in state-sponsored enterprises or private- enterprises.

3) Inflation, essentially, is a fiscal device since it is a uniform tax-subsidy system.

4) Elaborate financial system, a debt-asset system, which brings about specialization of the functions of savings and investments.

This last method for mobilizing savings viz. An elaborate financial system is the major theme of this proposed research.Although the question of causality remains unresolved until now, the answer to this question has far-reaching policy implications and has, therefore, been a recurring subject in the literature on financial markets and economic development. One could argue that only in the case of supply-leading, is there a need to direct attention to developments in the financial sector leading to adoption of active financial policy to stimulate financial development as part of a development strategy. In the case of financial development arising spontaneously as the economy grows, these developments are less important, thus, the concentration is more on developments in the real economy. To circumvent the problem of establishing the direction of causation between financial development and economic growth, many authors have simply assumed that financial development leads to economic growth. However, the demand-following hypothesis cannot be rejected, at least not on theoretical grounds. market circumstances. These circumstances are, in the extreme case, unknown and cannot be observed by individual savers and investors because of high monitoring costs. In contrast, financial intermediaries are better informed since they have special relations with one or both market participants and they may specialize in acquiring market information and channel this information to market participants. In this way, they contribute to smoothen the process of shifting financial resources from savers to investors.

CONCLUSION

During the last few years, the analysis of economic growth processes has changed, stimulated by the development of models in which the growth process becomes endogenous. These models emphasize the initial conditions of a country and policy issues which influence their development through time as determinants of the differences in economic

growth rates between countries. One important issue, studied extensively in these models, is the influence of the initial stock of human capital on long-run economic growth.

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