CHAPTER 1
INTRODUCTION

It is well recognised in the literature that the financial system\(^1\) plays a critical role in the process of economic growth (Goldsmith, 1969, McKinnon, 1973, Shaw, 1973). The role of the financial system as a facilitating factor for growth essentially stems from one of its basic functions—mobilisation and allocation of savings brought about through the process of financial intermediation\(^2\) (Bhatia, Rattan and Deena Khatkhate, 1975). Looking at this the other way round, the intermediation process supports increasing capital accumulation through the institutionalisation of savings and investment and as such fosters economic growth.

In the literature there has been a long-standing debate on the direction of causality between the two variables, that is, whether financial development causes higher growth (Supply leading) or vice versa (Demand following) (Patrick H, 1965, Porter R.C. 1966).\(^3\) Though this issue remains still inconclusive, it has been well recognised and firmly established that the process of financial development and economic growth are closely intertwined and they foster each other in a mutually reinforcing manner; so that the real and financial parts of the economy grow simultaneously (Jung, W S. 1988).

While recognizing such propositions, however, there has been a growing perspective that the interlinkages between the two processes and their co-movement are not as simplistic as proposed by the received theory. As per the limitations imposed by spacio-temporal specificities, the nature and degree of relation between the two would get diverged from the conventional wisdom (Chandavarkar A, 1992, Cho and Khatkhate, 1989). Received theory, though it recognised the possibilities of such departures and contradictions, has shown a tendency to downplay its significance in theoretical framework and policy formulation.

As an alternative, country/region-specific or issue specific research is being suggested for drawing better lessons on financial sector development and on its relationship with economic growth and thus evolving an appropriate policy menu to address the pressing financial and development problems of any country. Such a research has much relevance in a multi regional economy like India, noted for higher degree of heterogeneity in socio-
economic development among the regions. Besides, the country has adopted financial sector
reforms since the early'90s. The theoretical underpinnings of the reforms, as is noted by
some writers, are essentially the preconceived notions of financial development, noted for
their narrow base (Williamson, 2000, Chandrasekhar C P and Ghosh, J 2002). They are
perceived to be less accommodative of spatio-temporal differences (Shetty S L, 1997, Ram
Mohan T T, 2002). Being so, region-specific, issue-specific studies may help to evolve
broad-based and inclusive financial policies and thereby make correction, if needed, in the
present reform policy.

Keeping the above in view, an attempt is made in the proposed study to address the
nature and role of financial intermediation in economic development in a regional context
i.e., the State of Kerala in the Indian Union. It is done by examining the trends in financial
intermediation by the banking system, particularly the Scheduled Commercial Banks
(SCBs), the dominant player in the financial system in the State as well as the country,
against the backdrop of its real economy.

1.1 THE PROBLEM

Kerala seems to have a historical tradition of banking. The banking intensity in the
State was much higher than in the country even during the early years. Thus among the
Provinces and States of India prior to independence, the erst-while Princely States of
Travancore and Cochin in the present State of Kerala had the smallest average number of
people served by a bank office. The range of area served by an office of a commercial bank
was also the lowest (GOI, 1953). The role of the banking system in financial intermediation
seems to be evenly matched between deposit mobilization and credit disbursal as reflected
in higher Credit-Deposit (C-D) ratio. The ratio was estimated to be more than 80 percent in
1935 (Oommen MA, 1976).

The historical lead that Kerala had in financial infrastructure development could be
explained, to some extent, in terms of commercialisation of agriculture and growth of trade.
It seems that the region has experienced buoyancy in its productive sectors during the pre-
independence period as well as during the immediate decades succeeding it. The better
banking sector growth when looked against the State’s economic growth may lead one to
suggest the existence of a symbiotic relationship between banking and productive sectors of
the State’s economy. The State’s real economy and the banking sector during the earlier period seem to have infused energy to each other.

Though the gap in banking infrastructure development between Kerala and all India got narrowed down over the years, the historically better position of the State in banking infrastructure still continues. In the average number of offices per lakh population, the position of Kerala is much ahead of All-India. The trends in the financial intermediation as reflected in the C-D ratio, however, shows divergence from the historical experience. Having remained reasonably high till the late ‘80s, the C-D ratio of the banking system in Kerala has fallen drastically since then and reached a very low level. Thus from more than 60 percent during the late ‘80s, the C-D ratio of the Scheduled Commercial Banks (SCBs) in Kerala has fallen to a palpably low level of around 40 percent during the early years of the present decade.

Given the significance of C-D ratio as a measure indicating how the banks do undertake their intermediating role and thereby contribute to economic growth, the falling C-D ratio in Kerala draws our attention and raises the question: What brought the C-D ratio down or where it has happened? Also, what does it imply to the State?

The decline in the C-D ratio of the SCB system that the State witnessed over the years is to some extent an all India phenomenon. The experience of the State, however, stands out in some respects. The C-D ratio in Kerala which was relatively higher than that of India during most of the years in the ‘70s and ‘80s, turned out to be trailing behind the all India since then. The gap between the two got widened over the years. Compared to all India, the phenomenon of falling C-D ratio has started relatively earlier in Kerala and has been much sharper in the State. The steadier and much steeper fall in the ratio in Kerala, as against the all India situation, signifies some state specific factors, apart from the national economic policies in the making up of the receding C-D ratio in Kerala.

Juxtaposing the trend of the C-D ratio against the economic performance of the State, it is found that as against the historical experience of the better C-D ratio coinciding with fairly good economic growth, there took place a situation of higher C-D ratio coinciding with rather poor growth of the economy during the ‘70s and ‘80s and the reverse of that i.e.; the falling C-D ratio, coinciding with better economic growth since the late ‘80s. Low C-D ratio, being indicative of poor banking intermediation and vice versa, this
divergent growth behaviour between banking and economic variables raises serious concerns regarding the role of banks in the State’s development. Though higher C-D ratio suggests better mobilization of financial savings in the form of bank deposits, it contradicts the notion of increased banking activity in the form of more credit deployment coinciding with buoyancy in economic performance. The low C-D ratio, prima facie, indicates asymmetric financial intermediation by the banking system in the State. Also, the lack of correspondence between banking and economic variables, in its turn, may tend one to doubt whether a drift in the relationship between banking and economic variables is taking place in the State.

Admittedly, the phenomenon of falling C-D ratio and its low level has attracted much attention in the State. It has raked a series of debates and public discussions in which banking authorities and political leaders/activists took part actively. Consequently, divergent views have been aired; allegations and counter allegations followed. Two broad perspectives, however, came out of these. While one view attributes the problem of falling C-D ratio entirely to the State’s lack of development efforts and poor investment climate, the other finds fault with the banking system operating in the State. The SCB system is accused of meting out discriminatory treatment towards the State. Their operations in the State, is blamed of undermining the developmental efforts in the State and helps only to funnel resources to other regions/States. Such contradictory positions of the issue still continue.

It is often pointed out that the C-D ratio does not provide a complete picture of the extent of resources deployed by banks in a particular geographical area as it excludes investment in government securities and marketable instruments in a State. The credit plus investment deposits (C+I: D) ratio, which takes into account such investments along with credit disbursal by the banking system also, however, shows a falling trend in the State over the years. It has now reached a low value.

Another noteworthy aspect in this regard is that the organised financial intermediaries other than SCBs, which operate in the State’s financial system like co-operative banking institutions, All India Financial Institutions (AIFIS), too have shown progressive deceleration in their credit disbursal. C-D ratio is made up of credit as well as deposits and is reflective of two-way banking intermediation. The ratio falls when deposits increase at a rate higher than that of credit or the credit falls at a rate higher than that of the
former. Hence, to understand the issue, two questions are to be answered. What is the pace of their relative movements? What made the deposits grow or what made credit grow unmatched with deposits? Prima facie, lower credit absorption capacity or lower demand for credit will lead to this.

Answers to these questions, from a priori understanding, rest with the structure and composition of deposits and credit. The trend, pattern and composition of credit and deposits in turn are reflective of the level, pattern and composition of investment in the economy. All these are to be mirrored in the growth and structure of the economy. Hence, answers to the asymmetric intermediation by the banking system in Kerala as reflected in their falling C-D ratio would lead one to explore the growth and structural changes in the banking infrastructure, its deposits mobilisation, credit disbursal and its interlink to the developments in the State’s economy. Given the interlinkages-complementary as well as competitive- the commercial banking system may have with other intermediaries and instruments in the financial sector, it may also lead one to enquire the linkages that the former have with other players in the financial system. Thus an understanding of the process of the intermediation by the financial system as a whole and its links to the development process is required to understand the issue of C-D ratio. Hence, in the present study, we propose an analysis on these lines. We are left with very little systematic information on the intermediating functions other than those of the banking intermediaries and therefore have confined the analysis mainly to banking intermediation and its links to economic growth. The approach will be one which takes into account the overall Indian context, in which the Kerala experience is embedded, for the specificities of Kerala highlighted will be important and meaningful only if considered within the overall Indian economy. An analysis of this nature may broaden and deepen our understanding of the State’s development experience.

While conducting the enquiry, we will try to give answers to queries like; what is the nature of the phenomenon of falling C-D ratio and the emerging financial intermediation by the banking system in Kerala? How and where does the fall in the C-D ratio take place? Whether Kerala’s situation is different from that of India? If it is different, how and why it is so? Has it got something to do with the peculiar pattern of Kerala’s development often referred to as the Kerala model of development?
1.2 REVIEW OF LITERATURE

1.2.1 Theoretical Perspectives

The issue of the relationship between financial development and economic growth has extensively been dealt with in the literature (Gurley and Shaw 1960, 1955, Cameron 1967, Minsky 1967, Patrick H T 1966, Goldsmith 1969, McKinnon R.I, 1973, Townsend 1983, King R G and R. Levine 1993, Pagano 1993). Theoretical discussions on the nature of the relation between financial development and economic growth have postulated a positive relation between the two; increase in financial intermediation accompanies growth. Regarding the sequence, a two-way relation between financial development and economic growth is identified (Berthelemy, J C and A. Varoudakis, 1996). On the manner in which the financial sector facilitates growth, essentially three ways are identified: (1) by providing the savers with different varieties of financial assets to meet their diverse preferences, it enables them to increase their savings, (2) by transferring finance to ultimate borrowers it raises investment and, (3) by bringing about a better allocation of investment, the productivity of capital is improved. While the financial sector favours growth through the mobilisation and allocation of savings, the process of economic growth stimulates and encourages higher participation in the financial markets, which promotes the creation and expansion of financial institutions (Greenwood J, and B Jovanovic 1990).

At the policy level, there emerged two divergent views on the type of institutional framework that is required to achieve better financial intermediation. The financial liberalisation literature, the dominant line of thinking between these two, underlies the significance of market forces is bringing about efficiency in the credit system and thereby its allocative functions (Fry M J, 1988, 1982, World Bank, 1989). Asymmetries in financial intermediation or unevenness in financial development between regions is assumed away for the reasons of overall allocative efficiency that the free play of the market forces would bring in. The lower use of credit in an area, it is hypothesised, would be compensated by better use of credit in other region/s where the returns of capital are high (Capiro, G I Atiyas and J Hanson, 1994).

The alternative view of financial intermediation, called ‘financial repression’ in the literature, has brought the problem of asymmetric financial intermediation to the fore. It has doubted the efficacy of the market as a mechanism to achieve comprehensive development
and advocated government intervention in financial/banking system for its better developmental effects—allocative as well as distributional. Studies of these sort stressed the need to take cognizance of a number of factors such as the historical base in financial sector development in different regions, the policies and programmes to reduce regional disparities and their effects, the profiles of agriculture, industrial and infrastructural development in various regions/states, etc to understand the issue of disparity in the growth of financial infrastructure and asymmetric financial intermediation (Khatkhate, Deena 1998). Credit allocation should be deliberate rather than market-driven (Raj K-N, 1974).

Having discussed briefly some of the broad theoretical issues on financial development and economic development, let us now turn to some of the empirical studies related to them. Indeed, the theoretical formulations on the nature of relationship between financial and economic development mentioned above were based on the corroborative evidence from numerous empirical studies. The praxis context of many of those studies, particularly of the financial liberalisation literature, being advanced capitalist countries, and that too being in a national framework, they may not be a valid characterization in the Indian context particularly in the setting of a region like Kerala, whose model of development has been rather unique.

1.2.2 Empirical Studies

The hypothesis of the positive relation between financial intermediation and economic growth was put to test empirically in the context of the African Countries by Bhatia, Rattan J. and Deena R. Khtarakhate (1975). For many of the African Countries, no definitive relationship between financial intermediation and growth could be discerned. The probable reasons for its absence were attributed to the alternative fiscal technology or leakage of savings or market imperfections thwarting productive enterprises. Among the three, the last one is found to be more probable. The study seems to be supportive of one of the commonly shared views on financial intermediation that though necessary, it is not a sufficient condition for growth and development.

Documenting the historical evolution of the Bank of Nova Scotia during 1880-1910, the uneven financial intermediation in the form of lower credit deployment in relation to deposit mobilisation by the banking intermediary in a multi-regional context was highlighted by James D Frost (1985). The Bank of Nova Scotia that was begun as a
regional bank in one of the Maritimes provinces in Canada by the early 30's of the 19th century got transformed into a national financial institution by the first decade of the 20th century by setting up branches outside the region. Having assumed the national character, the intermediating role of the bank in the region had turned out to be asymmetric – deposits exceeding loans. For the bank, the Province became an area of surplus savings and enormous sums of money were drained away from the region. However, people in the region resorted to local banks for their credit needs. Though it was for commercial considerations, that the regional bank expanded its operations in other regions, over the years, it became detrimental to the interests of the region. The ‘concentration and centralization of capital and industry’ that was taking place in the central parts of Canada was identified to be an important factor for such an evolution.

1.2.2.1 Studies at All India Level

Coming to the Indian context, All-India Rural Credit Survey (RBI 1954) had brought out the higher degree of unevenness in financial infrastructure development and resultant financial intermediation among States/regions as a serious case of concern. Modern banking institutions were found to be concentrated more in commercial and business centers like Bombay, Calcutta and Madras. Region-wise, their presence was found more in central and southern regions. Sector-wise examination of the credit structure showed very little involvement of the formal institutions-co-operative as well as commercial banks – in the agricultural sector. The informal segment, despite its exploitative nature, was identified to be playing a prominent role in the overall credit system. As against all-India, Travancore and Cochin had been cited as regions noted for higher involvement of formal institutions in rural credit. Historical factors as well as structural pattern of the regional economy like commercialisation of agriculture and trade were identified to be the facilitating factors for this. The next survey on similar line by RBI titled ‘All India Rural Debt and Investment Survey, 1961-62 reestablished the higher degree of inequality among regions in credit availability and credit outstanding (RBI 1965).

The subsequent decennial All India Debt and Investment Surveys of RBI, respectively for the years 1971-72 and 1981-82 showed the decline in the importance of informal segment in overall credit structure (RBI, 1977, 1987). However, they were still prevalent to be reckoned with. Though the degree of unevenness in the use of institutional credit among regions had come down, these surveys pointed out the continuation of the
problem so as to be attended to. Considering the country as a whole, the credit use was found to be much ahead in States like Maharashtra and Gujarat-two States whose overall economic performance was much ahead of all-India average. In almost all these studies Kerala along with the other southern States is identified as a region enjoying higher degree of banking intermediation.

Other important institutional level studies, namely Organisational Framework for the Implementation of Social Objectives-Report of the Study Group of National Credit Council (RBI, 1969), Report of the Banking Commission (RBI, 1972), Report of the Committee on Functioning of Public Sector Banks (RBI, 1978), Report of the Committee to Review the Working of the Monetary System (RBI, 1985), A Review of the Agricultural Credit System in India-Report of the Agricultural Credit Review Committee, RBI, 1989) also pointed out the unbalanced growth of the credit system between regions and sectors. The organizational unpreparedness of the banking system was highlighted to be a key factor explaining its failure to meet the social objectives of banking in the form of regional evenness and balanced economic growth. Qualitative changes in the mode as well as manner of financial intermediation were highlighted to realize the social objectives of banking.

The Narasimham Committee report (RBI) 1991, which ushered in banking reforms in the country since then brought forth the inefficiency of the credit system. The higher social orientation as well as increased political (Government) intervention was identified as factors contributing to inefficiency. Instead of financial repression, progressive financial liberalisation was advocated as the policy plank. International standard of sound banking was advocated to be followed by the banking system in the country.

Various committee reports and surveys, which examined the credit system, highlighted unevenness in financial intermediation. It was manifested in poor credit deployment or credit use region-wise and economic sector wise. In the context of the declining trend of C-D ratio in the late '80s, RBI (1992) conducted an enquiry on the status of C-D ratio of SCBs in India. It identified the improvement in the ratio in the relatively backward States like Madhya Pradesh and Bihar during the post-nationalisation period. It had attributed the lagging behind of undeveloped regions and States in C-D ratio to the relative backwardness in regard to infrastructural development and general inadequacy of their credit absorptive capacity. Direct loans to institutions engaged in infrastructural development, higher quotas of market borrowing for less developed States, establishment of
special infrastructural corporation for the eastern region, directing entrepreneurs to set up units in poor region, diversion of public sector undertakings deposits to less developed regions, bank headquarters in underdeveloped States etc. have been suggested to resolve the issue.

Coming to studies by individual scholars, Basu (1979), while analysing agricultural credit in 283 selected districts for the year 1973, found that there were wide variations across the States with regard to the growth of bank offices and per hectare credit to agriculture. The inter district disparity measured in terms of coefficient of variation was very high. The major share of bank credit in 1973 went to Maharashtra and West Bengal. Within these two States, Bombay and Calcutta availed of the bulk of the loans, which showed that the degree of urbanisation has been a determining factor influencing the regional disparity in the intensity of credit operations of commercial banks. Even the C-D ratio continued to have wide regional divergence. It ranged from 7 to 245 percent with a coefficient of variation of 98 percent. The study also sought to trace the determinants of the regional disparity of the agricultural credit by using regression method and found that certain banking, institutional and productivity variables are responsible for this variation. He found that in quite a number of States, the bulk of the agricultural credit goes to finance the plantations. But, even after deducting for plantation credit, Tamil Nadu, Kerala and Maharashtra, accounted for a good share.

Kannan (1987) constructed an index of banking development using the factor analysis technique for three time points, 1969, 1975 and 1985. The analysis was supplemented by estimating the economic distance between regions. It was found that there is no significant variation in the ranking pattern of States for the period 1969 to 1975, although there was a substantial reduction in disparities from 1975 to 1985. The industrially backward States of MP, Jammu, and Kashmir, Bihar, Assam, and Orissa had a low banking index, while Punjab, Maharashtra, Kerala, and Gujarat were well developed. The three main indicators that were used in the analysis were the population per bank office, per capita credit and per capita deposits.

Binswanger, Hans P.S Khandker and M R Rosenzweig (1993) examined the impact of the flow of commercial credit to agriculture. The study used data from 85 randomly drawn districts of India covering the period 1960-61 to 1981-82 and showed that the expansion of commercial bank branches accelerated the pace of agricultural investment.
Availability of banks is found to be an important determinant of fertilizer demand and aggregate crop output.

Using data for 1965-78, Eastwood R and Kohli(1999) has looked at the effect of directed credit on small scale industry. The bank credit channeled to small firms seem to have raised their investment appreciably. The study, however, identified severe financial constraints in the case of the small scale industrial sector. Ajit D and R.D Bangar(1997) looked at the issue for later years and suggested that the financial constraints continued to exist.

The trends in credit deployment by industry, bank groups, by rural and urban areas and by States over the 7-years of the post reform era were examined by D. Narayana (2000). The post-reform banking trends are found slowly reversing the trend of the two decades since bank nationalisation. In the deployment of commercial bank credit, serious regional and sectoral inequalities are identified in the post-reform years. There has taken place a drastic reallocation of total commercial bank credit from poor agricultural States to Delhi, Maharashtra, and Tamilnadu. The new private banks and foreign banks are found to be increasing their presence in areas with banking habits and in the emerging business of financing personal and professional services.

The EPW Research Foundation (2004) has undertaken a stock taking of the progress made by scheduled commercial banks over the 30-year period since 1972. The analysis has found that in the post- reform years, the banking system has faltered in their traditional developmental role of savings mobilisation and provision of productive credit. The study noted the decline in rural branches, persistence of inter-regional disparities, fall in priority sector lending, fall in credit of smaller size and credit to informal sectors.

Using such a long period data S.L.Shetty (2005) has examined banking performance in the pre and post reform periods and has brought out the emerging, regional, sectoral and functional distribution of bank credit. The study noted the departure from supply based banking development. The study emphasized the importance of promoting financial intermediation by spreading branch networks, mobilizing savings and bringing about better regional, sectoral and functional reach of institutional credit in the country.

Pallavi Chavan (2005) has analysed the regional distribution of rural banking in India between 1975 and 2002. Liberalisation of the banking sector in the 1990s is found to
have weakened the link between commercial banks and rural areas. The credit to output ratio for agriculture during the 1980s showed steep rise. A reverse trend was noted in the '90s. There also took place a fall in rural C-D ratio. The decelerating tendency in rural credit and also the declining C-D ratio was felt more in historically unbanked States from the Northeastern, Eastern and Central regions. States of Maharashtra and Punjab emerged as major gainers in terms of the share of total rural credit advanced. Banking sector liberalisation seems to have reversed the process of balanced regional development of the rural banking.

Apart these, there exists a host of studies at individual level that shed light on unbalanced financial intermediation. The incidence of inequality within States has been pointed out to be a major cause for lower credit absorption. The difference in infrastructural development and social and demographic indicators of development like literacy, life expectancy, etc; is pointed out to have a strong bearing on the evolution of the credit system.

Studies at the individual level, generally speaking, seem to be restricted in their scope, for their discussion is confined to the role of banking in the growth of a particular segment of the economy such as industry or agriculture.

1.2.2.2 Kerala’s Experience

Though there are numerous studies on the unique development experience of Kerala, studies focusing on the financial sector development are few.

One of the pioneering studies in this regard is the Travancore Banking Enquiry Committee report of the Government of Travancore, dated 1930. The report made reference to the ancient financial institution, namely chitty or kuri, that existed in the northern taluks of Travancore and the metamorphosis from ‘Grain banks’ of old, run by indigenous bankers of central Travancore to modern joint-stock bankers. It was the profitable use of surplus funds that led to the formation of many joint stock banks. The contribution of banks to the financing of agriculture was found to be significant during the decades of the 1920s.

The Travancore-Cochin Banking Enquiry Committee Report (Government of India, 1956) in the post-independence period traced the development of banking in the two regions of Travancore and Cochin. It inquired into the role played by the banks incorporated in the region in financing economic activities such as agriculture, industry, commerce and trade.
According to this study, the average number of people per bank office, in the Travancore-Cochin region was the smallest in the whole of India. It was also noted that the banks in the region had penetrated into the rural areas.

Oommen (1976) made an attempt to trace the early history of banking in Travancore and Cochin. He offered some explanatory hypotheses about the nature and pattern of the growth of banking in the region. The community or sectarian origin of ownership, the rural area bias, over extension of credit, and predominance of small accounts were identified as the salient features of banking in the region. The spatial concentration of banking in Tiruvalla and Trichur too was observed.

T. T. Sreekumar (1995) examined the origins of the co-operative movement of Travancore and found a chaotic existence of it in the initial years. The study also deals with the history of the system of government directly participating in credit and found the final collapse of it by 1940. Considering the two cases of state intervention in the final credit market, one direct through the system of providing agricultural loans and the other indirect through the establishment of the co-operative movement, he argues that the inability of the government to cope with the sharp social and economic divisions in the peasant society has been among others, a fundamental reason for the failure of these institutions.

The Kerala State Planning Board (GOK, 1982) made an effort to understand the performance of commercial banks in Kerala after nationalisation. This study was confined to a quantitative assessment of the performance of nationalised banks, and looked at the mobilisation of deposits, trends in credit expansion, and the sectoral distribution of bank advances. Even though the number of bank offices in the State was more even than in other States, some districts like Malappuram, and Idukki lacked banking infrastructure. Ernakulam was found to be the best banked district in the State followed closely by Trivandrum. It accounted for 22 percent of the deposits and 30 percent of the credit disbursed in the State. Idukki, Malappuram and Palakkad were way behind.

Ram Babu (1996) examined the inter regional disparities in banking development in Kerala in the context of regional variation in economic development of the State. The banking development in Kerala from the beginning of the present century has been characterised by a widening of the differences between northern and southern Kerala. It has been pointed out that faster commercialisation, infrastructure development and greater
degree of urbanisation contributed to better banking development in southern Kerala. To understand the factors responsible, he undertook an inter district analysis of banking performance in the State for the period 1985 to 1993. While Ernakulam, Qulion, Trivandrum and Kottayam came out as the most advanced in terms of banking development, Idukki (in southern Kerala) and the northern Districts show a relatively poor performance. The study also examined the structure of SCB deposits and credit. Compared to the earlier studies, it is more dynamic in approach. Along with commercialisation, the influence of foreign remittance is highlighted to be an important factor explaining dynamism in Kerala’s commercial banking system. While examining SCB credit, the study pointed out the increasing dominance of tertiary sector in credit.

A task force with D D Avari as chairman examined the issue of the falling C-D ratio of scheduled commercial banks in Kerala (Canara Bank, 1994). Among other things, it recommended 1. to expand small agricultural loans, 2. to bring about better co-operation between various government departments and banks, 3. to formulate a composite loan policy for financing homestead farming, 4. to create a conducive investment climate, 5. to extend credit in a big way to areas like agriculture marketing, food processing, tourism, housing, education and infrastructural facilities and 6. the government to evolve schemes for tying up non-resident deposits with productive ventures. The study was noted for its data gap as well as normative approach.

The issue of low C-D ratio was dealt at individual level by Narayana D (2003). The study underlined the smaller size of credit and the much small flow of credit to industry as the explanation for the low C-D ratio. The study was based on a single year data and it discussed only the credit side of the issue.

Yet another individual attempt is the one made by Jeromi P.D. (2003). The study has brought out the relatively lower growth of credit deployment in the State during the '90s. Lower credit absorption capacity, as reflected in lower per capita credit and credit per account in the State is suggested to be the major reasons for lower credit growth.

Jeromi P. D (2005) has analysed the issues relating to agricultural credit in Kerala against the backdrop of the performance of the agricultural sector. The study finds that the outreach of formal financial institutions for providing agricultural credit is relatively high in the State, the loans issued for agriculture and allied activities by financial institutions are
fairly good. The size of agricultural credit, however, is small. The structure of loans to agriculture shows the higher significance of short-term loans. The study identifies considerable credit potential in the agricultural sector, implying lower degree of intermediation by the commercial and co-operative banks in the agricultural sector.

Sunanda (1991) in her study on the institutional agencies for agricultural credit in Kerala reviews the socio-economic background of the origin and growth of banks in Kerala. While discussing the agricultural credit disbursed by these institutions, she highlighted the prevailing interdistrict disparity. Using principal component analysis, she found that in per hectare credit, Ernakulam and Trichur stood highest while Palakkad ranked the lowest in the State.

Though the financial sector per se was given relatively less attention in the context of Kerala, the development experience of Kerala, as noted before, has aroused considerable interest and debate in recent years as the region exhibits the paradoxical feature of social development and economic backwardness, hailed as the Kerala model (Nair 1997, Krishnan 1996, Dreze and Sen 1996, Franke and Chasis 1982, CDS 1975). Attention has also been given to the sustainability of the model in the wake of prolonged economic stagnation, growth in unemployment and fiscal crisis (Balakrishnan, P 1999, George K.K 1996, 1999, Oommen M.A 1993, Subrahmanian K.K 1990, Kannan K.P 1990). Besides the prevalent resource-endowment explanation, one of the emerging views on the development crisis of the State is that the structure of the regional economy is narrowly based and this acts as a cause as well as consequence of much of the dilemma in the development process of the State. It has also been suggested that in order to get a comprehensive understanding of the development crisis, the problem should be addressed against the socio-economic background of the State in the pre- as well as the immediate post-independence period.

Recent discussion on the growth experience of Kerala has portrayed a ‘turnaround’ in the State’s economic growth (Chakraborty, A 2005, Kannan K P, 2005, Subrahmanian and Azeez, 2000, Harilal and Joseph, 2000). The State’s earlier achievements in education and health are pointed out to be factors contributing to it. However, there are alarming warns to be cautious of interpreting the ‘turnaround’. Also, doubt has been raised regarding the continuation of the growth process, particularly against the background of mounting unemployment (Oommen M A, 2005).
From the brief review attempted above, it could be seen that though there exists theoretical discussions providing insights into the problem, empirical studies pertaining to the issue, particularly in the case of Kerala, is highly inadequate. The available studies on the banking system in the region are less comprehensive and less revealing of the present day developments. Even those later studies that focus on the issue have stopped short of explaining the structural link between the banking and real sectors of the economy. The dynamic forces of supply and demand in commercial banking development and their interlinkages to the whole credit system within the State and within the country are not adequately discussed to get a comprehensive understanding of the issue. The present study attempts to fill this gap in the development literature of Kerala. The discussion may be conducted in such a way that the links between the two broad processes—of the development of the banking sector on the one hand, and of the economic processes on the other—may be looked at all through. Such an attempt which gives an analytical description of the development in the banking system will explore how it facilitates the process of economic development and is expected to provide further insights into the issue of sustainability of Kerala’s development experience discussed widely at present.

1.3 OBJECTIVES OF THE STUDY

Broadly, the objective of the study is to explore the interrelationship between financial intermediation and economic growth in Kerala. In order to pursue this objective, we will examine:

1. the trends in intermediation by the banking system in Kerala over a long period
2. the trend and pattern of bank deposits and credit in the State
3. the trend in the growth and performance of financial intermediaries like the All India Financial Institutions
4. the trend and pattern of Kerala’s economic growth
5. the links between banking and economic variables, and
6. the difference in the growth trends of banking and economic variables between Kerala and India and the probable reasons for the difference.
1.4 METHODOLOGY AND DATA SOURCE

The purpose of the study, as noted before, is to provide an analytical description of the interrelationship between banking and economic variables. Being exploratory in nature, the study did not have any specific hypothesis to begin with.

To capture the links between financial intermediation and economic growth, the long term growth trends of banking variables and economic variables at an aggregate and very disaggregated levels are traced out. The analysis is carried out in a comparative framework in the sense that the trends of the banking and economic variables in Kerala are traced over time and juxtaposed against the all India situation. The growth trends of the banking variables are also being compared with that of the trends in the non-banking financial intermediaries.

The study is conducted in a historical context. In order to arrive at a comprehensive framework for analysis, the study will try to weave together the existing literature on economic development, particularly in the context of Kerala. To provide the empirical support for the analysis, secondary sources of data are used. The major sources for banking data is the Basic Statistical Returns (BSR), published by the Reserve Bank of India (RBI). Other important sources of banking data include Statistical Tables Relating to Banks in India and Report on Currency and Finance, both published by the Reserve Bank of India; the Statistical Statements Relating to the Co-operative Movement in India and the Handbook on Co-operative Movement in Kerala, published by National Bank for Agriculture and Rural Development (NABARD), RBI and Registrar of Co-operative societies, Government of Kerala (GOK) respectively. Information on banking intermediaries is also availed of from State Level Banker’s Committee Reports.

Data on All India Financial Institutions is taken from the Report on Development Banking in India published by Industrial Development Bank India (IDBI). We have also availed of the information from Annual Reports of National Savings Organization, Government of India and the Annual Reports, Kerala State Financial Enterprises, Limited, Government of Kerala. In addition to these, macro economic data from Central Statistical Organization, GOI, Census of India, and State level economic data from the publications of the Government of Kerala like Kerala Economic Review, Statistics for Planning, etc. are made use of.
The period taken for the analysis is the 32 years from 1972-73 to 2002-03. The choice of 1972 as the initial year is due to the fact that our main source of data, the Basic Statistical Returns (BSR), giving detailed information on banking performance on a uniform basis came to be published only from this year. Data on bank advances as per the State of utilisation or by industrial categories came to be collected for the first time only from 1972 through BSR. Only simple statistical methods are used.

To analyse the growth behaviour of the variables, mainly the exponential growth rate is used. We estimate the annual growth rates by fitting a semi-log \( \ln Y_t = a + bt + e \) trend. The regression coefficient \( b \) yields an estimate of the compound growth rate.

1.5 CHAPTER SCHEME

The study is divided into seven Chapters including this introductory chapter. Chapter two traces the historical evolution of the banking infrastructure in Kerala. The historical review is done so as to provide a comprehensive framework for the subsequent analysis.

Chapter three examines the trends in financial intermediation by the scheduled commercial banking system in Kerala during the post-bank nationalisation period. Kerala's situation is compared with the All-India situation. State-wise, population-wise and bank-wise details of the C-D ratio are spelt out here. The performance of the SCBs is compared with that of the Co-operative banking system. Also, the growth trends of these two banking intermediaries are compared with those of the All-India Financial Institutions (AIFIs) consisting mainly of Development Banks.

Chapter four begins with an analysis of the overall performance of the Kerala economy. The intermediation trends of the banking system is looked against the backdrop of the State's economy, so as to identify the nature and character of the relationship between the banking and economic variables at the aggregate level. It is followed by an analysis of the broad sectoral characteristics of the SCB deposits and credit on the one hand and the State domestic product on the other. This chapter also looks at the rural, semi urban and urban characteristics of SCB deposits and credit.

Chapter five analyses the credit structure in a further disaggregated manner and identifies some of the important factors in the making up of the pattern of credit to different sub sectors of the State's economy in the context of their performance. Chapter six attempts
district wise analysis of the banking intermediation trends. Chapter seven brings together the major findings of the study.

1.6 LIMITATIONS

The scope of the analysis, mainly due to the inadequacy of data, is restricted to intermediation by the banking system; the entire financial system is not covered. Even with regard to the banking data, there exists considerable gap. The economic activity-wise information available is largely related to the credit part of financial intermediation; very little on the deposits side. Hence the sector and sub sector wise analysis of the links between banking and economic variables is largely confined to bank credit. Further, there is definitional differences between the data provided by the banking system and National Accounts Statistics (NAS) at the disaggregate level. So the two sets of variables do not conform exactly at the sub-sectoral level.
End Notes

1. **Financial system of a country consists of financial institutions, markets instruments and services, which facilitate the transfer of funds.** Financial institutions range from the informal types comprising pawnshops, money lenders, chitties etc to the formal ones made up of banks, pension funds, insurance companies, brokerage houses, investment trusts and stock exchanges. **Financial instruments range from deposits, cheques, credit cards, bonds and stocks to the more exotic-futures, swaps etc of high finance.** Markets for these instruments may be organised formally or informally. The informal institutions and markets of finance, it is expected to get eclipsed as economies grow. Depending on the relative significance of capital market or the banking sector in the overall financial system in an economy, two broad institutional possibilities i.e. capital market based system and the bank-based system are identified in the literature. The capital market-based systems are generally characterised by highly developed capital markets with widely dispersed ownership of equity and debt instruments and relatively lower involvement of banks in either allocation of funds or the ownership of financial assets as in Anglo-American line. The bank-based systems, by contrast, are characterised by the dominance of banks in the financial system. The latter is broadly of two types. One is characterised by a small number of universal banks that are actively involved in the long-term financing of investment activity of the non-financial system as found in Germany. The second is the State-directed credit-based system where the government participates actively in allocating credit as found in France and Japan. (Gerschenkron, A 1962, Zysman J 1983). The financial systems found in India and many of the developing countries including the Newly Industrialised Countries (NICs) broadly come under this category.

2. **The financial system provides payment services, mobilize savings and allocate credit.** They also limit, price, pool and trade the risks resulting from these activities. These diverse services are used in varying combinations by households, businesses and governments. Though a financial system's contribution to the economy depends upon the quantity and quality of its various services and the efficiency with which it provides them, its function as a conduit of resources from savers to investors acts as central to the development process.

3. **The 'demand-following' hypothesis suggests a pattern of high economic growth leading to the emergence of more developed financial systems with a wide range of**
financial instruments, financial assets and transactions; a reverse relation has been suggested by the 'supply-leading' hypothesis. Such theorizing led to two approaches: 'supply-leading approach' and 'demand-following approach' to financial development. According to the former, financial development appears as a consequence of the development of the real sector, which implies continued expansion of markets and growing product differentiation, thus acquiring more efficient risk diversification and better control of transaction cost. This type of financial development thus plays a rather passive role in the growth process. Conversely, supply-leading financial development precedes the demands for financial services and can have an autonomous impact on growth. Its role is essentially to mobilize resources blocked in the traditional sector to transfer them to the modern sector that is capable of promoting growth and to ensure that they are used to finance the most dynamic projects.

4. C-D ratio, by definition, is the ratio of total advances granted by banks to the total deposits mobilised, expressed in percentage. This indicates the extent of total advances made by the banking system directly to the customers out of the total deposits mobilised and is considered a simple and a useful concept to measure the extent of deployment of credit relative to the deposits mobilised. Being so, it is quite reflective of the nature of financial intermediation also.

5. The per capita Net Domestic Product (at constant 1970-71 prices) of Kerala (Rs. 460) was a little higher than the all-India average (Rs. 446) in the early fifties (Albin, Alice 1990). Further, Kerala's per capita manufacturing product was significantly higher (Rs. 48) than all India average (Rs. 37) in 1950 (Issac and Tharakan, 1986).

6. Investments that are included in the Credit plus Investment (C+I) ratio are those done by the banking system in State government securities, State undertakings, investment in share capital of State-based companies, investment in co-operatives, bonds issued by local bodies, etc.

7. Let \( Y = ABt \) where \( B = 1 + r \), and \( r \) is the compound growth rate of \( Y \). When the equation is estimated with \( \ln Y \) as the dependent variable, we obtain an estimate \( b^* \) for \( \ln B \). The antilog of \( b^* \) minus 1 yields an estimate for the compound growth rate i.e.; \( r \).