CHAPTER II
THEORETICAL AND EMPIRICAL FRAMEWORK

2.1 INTRODUCTION

The introductory chapter, inter alia, has made it abundantly clear that the present inquiry is primarily concerned with the study of NBFIs in relation to commercial banks and central banking policy. And as a part of that exercise, the inquiry attempts to bring to the surface the nature and extent of competition that NBFIs pose to commercial banks on the deposit front. It also critically examines the precise ways in which the lending policies and practices of the NBFIs narrow down the scope of monetary policy and make it less effective. Giving due weightage to the decisive role that financial infrastructure has in regional development, it makes a detailed study of the inter-state disparities in financial infrastructure with reference to NBFIs and commercial banks, and at the same time the inter-temporal trends in regional disparities are also examined. With the district of Bellary as the study area at the micro level, it makes a penetrating probe into the functioning of finance corporations—one of the variants of NBFIs—in relation to commercial banks and RBI's monetary policy. A few studies or NBFIs have already been made at various areal levels—global, national and district—to identify the directional and dimensional contours of the positive role of NBFIs in promoting
economic development as live links between the saving public and the investing public; some studies have also indicated their negative role viewed in terms of the competition they pose to commercial banks, the threat they pose to the effectiveness of monetary policy, and the black money they generate. One academic peculiarity of most of the studies done so far on NBFIs is that they centre round either the Gurley-Shaw thesis or the Radcliffe-Sayers thesis or both. As anywhere else in the world, in India too, economic development is characterised by the growth of NBFIs. And as anywhere else, they have been adversely affecting the growth of commercial banks through their competition for deposits, besides posing a threat to the effectiveness of RBI's policy of assisting growth with stability and justice. Of course, there is no uniformity in the regional spread of NBFIs in general and that of finance corporations in particular. The NBFIs have relatively greater concentration in the northern states, whereas the finance corporations in the southern states. The finance corporations, with the express intention to keep themselves off the regulatory net of the RBI have been adopting all sorts of means and methods to circumvent the rules and regulations of the RBI. In Karnataka, Bellary district has been experiencing a phenomenal growth of private finance corporations in the recent past. The review which follows is intended to supply a highly comprehensive theoretical and empirical framework for the discussion that takes place in
the subsequent chapters. Including the introductory section, this chapter consists of three sections. The second section discusses in detail the various theories developed from time to time to identify the role of NBFIs, the competition they pose to commercial banks and the threat they pose to the effectiveness of monetary policy. It also throws some light on the implications of the growth of NBFIs for monetary theory and policy. The third section makes an analytical survey of the various empirical studies related to NBFIs and finance corporations made at various spatial levels at different points of time.

2.2 THEORIES ON NBFIs

If the roots of NBFIs in their crude form are to be traced back to pre-Christ period,1 the roots of the awareness of their determining role in economic development, and the public concern about the possible implications of their growth for commercial banks and monetary theory and policy are to be found in the twentieth century. Having been convinced of the threat the NBFIs pose to the effectiveness of monetary policy, the monetary experts have developed a new theory which is popularly known as the 'liquidity theory of money' or 'the new theory of finance'. According to the new theory, the causal relationship existing between money and the volume of business activity or the general price level cannot be fully explained under the modern

conditions either by the Quantity Theory of Money or by the Income-Expenditure Theory. It is neither the income nor the volume of money, but the overall liquidity which is the basic concept linking the general business activities with the monetary conditions.\(^2\) According to Gustav Schmolders, not the supply of money, therefore, but the liquidity position of the business is the main factor of general business activity.\(^3\) R. W. Goldsmith's work\(^4\) was the first to highlight the growing importance of NBFIs and it induced a number of experts in money and finance to develop elaborate theories on NBFIs. The new theory has found its mature exposition in the Radcliffe Committee Report\(^5\) and in the writings of Gurley and Shaw,\(^6\) R.S. Sayers,\(^7\) Gusta

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Schmolders, J.M. Culbertson, Robert L. Bennett, Richard S. Thorn, Eugene A. Brinbaum. However, it is to be pointed out that the core of the theory is to be found in the work of Gurley-Shaw and in the Radcliffe Committee Report, and other works are mostly attempts to interpret, amplify and clarify the theses associated with the names of Gurley and Shaw, and Radcliffe and Sayers.

2.2.1 Gurley-Shaw Thesis

Eventhough R.W. Goldsmith's work is considered to be the pioneering work on the importance of NBFIs in the overall financial structure of an economy, it has not made any substantial contribution to the new theory of finance which

assigns a definite and determinate place to NBFIs. Gurley and Shaw happen to be the first to question the adequacy of the orthodox view about the dimensions of economic development. The orthodox theory, while emphasising the significance of real or goods aspects of development, ignores the financial aspects of development. And this one-sided view is not acceptable to Gurley and Shaw. They consider both the aspects to be important, and also identify a reciprocal relationship between economic development and financial development. They say, "Economic development is commonly discussed in terms of wealth, the labour force, output and income. These real or goods aspects of development have been the centre of attention in economic literature to the comparative neglect of financial aspects. Yet development is associated with debt issues at some points in economic system and corresponding accretions of financial assets elsewhere. It is accompanied too, by the institutionalisation of saving and investment that diversifies channels for the flow of loanable funds and multiplies varieties of financial claims. Development also implies, as cause or effect, changes in market prices of trading in loanable funds. Development involves finance as well as goods." In their opinion, thus, real economic development is invariably accompanied by financial development. This is indeed a major departure from the traditional thinking on economic development.

15. Ibid., P. 515.
Another important aspect of their theory which has significant bearing on the scope and effectiveness of monetary policy is concerned with the role of near-money liquid assets of the NBFIs. They opine that monetary policy to be adequate must take into consideration the financial intermediation done by NBFIs also. They consider commercial banks to be a part of the financial structure. They agree that the conventional dichotomy between commercial banks as creators of loanable funds, and financial intermediaries as brokers of loanable funds, is fallacious. For them, both banking and non-banking types of financial institutions are subsumed under one head and recognised to be similar in their role as suppliers of loanable funds. They maintain that all types of financial intermediaries can create loanable funds. As such, they find the present methods of credit control discriminate against banks in their competition with NBFIs, and therefore they contemplate the extension of central bank's regulatory powers so as to cover the NBFIs.

In this regard Gurley and Shaw assert that the rapid growth of NBFIs in the post war years in the United States has weakened the control of monetary policy on the economy, and the Federal Reserve System should extend its powers to cover the NBFIs to make monetary policy more effective.

Yet another significant dimension of Gurley-Shaw thesis is related to the threat that NBFIs pose to commercial banks. In their opinion, the threat manifests itself in the declining economic importance of commercial banks, particularly in terms of deposit mobilisation. Their reasoning is convincing: the NBFIs, being outside the purview of central bank's regulation, are not only capable of tapping untapped savings, but also in attracting away the deposits from commercial banks by offering relatively higher rates of interest; the commercial banks whose interest rates are regulated by the central bank, cannot offer competitive rates of interest either to attract new deposits or to prevent the flight of their deposits to NBFIs. In this way, over a period of time, with the growth of NBFIs, the commercial banks are bound to decline in economic importance.

To be very precise, Gurley-Shaw thesis, among other things, includes the following:

(1) Real economic development is accompanied by financial development.

(2) Financial development has taken the form of the tremendous growth of NBFIs and diversification and proliferation of financial assets. As a result, commercial banks have been declining in relative importance.
(3) The conventional dichotomy between banks as creators of money, and non-bank financial intermediaries as brokers of loanable funds, is misleading, if not fallacious.

(4) Monetary policy has become ineffective because the central bank is regulating only the relatively shrinking sector of commercial banking.  

2.2.2 Radcliffe-Sayers Thesis

The liquidity analysis which is very closely associated with the Radcliffe Committee Report, R.S. Sayers of England, Gustav Schmolders of West Germany, is generally referred to as Radcliffe-Sayers thesis. By and large, the advocates of this thesis emphasise more and more the policy implications of the liquidity approach. The prescriptions of the orthodox policy are not acceptable to this group of writers; the latter wish to substitute the general liquidity of the economy for the supply of money as the centre of monetary action. The Radcliffe-Sayers thesis hinges on the idea that the supply of money—the quantity the central bank can directly influence—is not the main lever of monetary action. The whole structure of interest rates, including the differential interest rate in vogue due to the activities of NBFIs, is of undoubted importance. The structure of interest

rates highlights the effects on the liquidity of the various groups of financial institutions due to a change in the rate of interest which has directly or indirectly influenced the level of total demand.22

The Radcliffe Committee opines that the main purpose of monetary action of regulating the aggregate demand for goods and services cannot be achieved by controlling the quantity of money alone. Therefore, it advocates the extension of the regulatory net so as to cover the entire liquidity position of the system. However, the Committee does not say that the supply of money is an unimportant quantity of money, but the committee views it as only a part of the wider structure of the liquidity in the economy.23 This idea of overall liquidity control directly affects the scope of monetary policy and its effectiveness. Monetary policy cannot claim to be effective if its control confines itself to supply of money and the credit created by commercial banks. The Policy to be effective need enlarge its scope so as to cover NBFI's also. In the opinion of the Committee the direct financial controls which operate upon banks alone are not only inequitable and insufficient but also mostly self defeating because, they merely shift the source of finance. Hence, the

23. Ibid., Paras 389 and 390.
question of introducing direct control over bank liquidity, raises at once, the question of parallel controls over all other competing institutions in the economy. According to Sayers, the supply of credit is no monopoly of banks; the power of the banks to create credit thus provides no justification for control of banks while other credit agencies are left uncontrolled. Control of banks becomes discriminatory since the bank deposits are merely the small change of the monetary system.  

From the foregoing views of the Committee and of Sayers, one gets the inescapable impression that monetary policy to be effective need extend controls to cover all the financial intermediaries in the economy. But, that is not the true intention of the Radcliffe Committee. In fact, the Committee rejects the view that the central banking policy could be made more effective by substituting for the traditional controls of supply of money a complex of controls over an indefinitely wide range of financial institutions. This intention of the Committee is made obvious when it says that such a prospect would be unwelcome except as a last resort not mainly because of its administrative burdens, but because, the further growth of new financial institutions would allow the situation continually to slip from under the grip of the authorities.  

However, the Committee does not  

say that the NBFIs should remain uncontrolled; it only says that all the control measures which regulate the operations of commercial banks should not be extended to NBFIs. The Committee insists on the regulation of NBFIs through the manipulation of interest rate structure. The Committee opines that the real force lies in the effects of changes in the interest rates on the liquidity of various groups of financial institutions which in turn, affect the liquidity of others. The significance of interest rate manipulation as a regulatory measure is mainly because of the importance assigned to overall liquidity rather than 'supply of money'. In view of this shift from 'supply of money' to 'liquidity' as the target of regulation, interest-rate structure, and not the supply of money, becomes the centre-piece of monetary action. The Committee further maintains that if for certain reasons the monetary authorities are inhibited in their manipulation of interest rates, no mere control of the supply of money can be expected to do much. 26 Commenting on the Committee's Report, Madaiah says: "Therefore, the final verdict of the Radcliffe Committee on the effectiveness of monetary policy in a developed financial system is that the potentialities of such a system are so great that a workable monetary policy could perform only a subordinate role or an emergency role. The Committee concludes that the only alternative for monetary policy is its subordination to fiscal and other policies in the normal times and its revival -

26. Ibid., Para 393.
for use in emergency conditions only. This seems to be too pessimistic and too sweeping a conclusion in the light of our analysis; for it is not too difficult to identify at any one time the particular financial institutions which are most likely to frustrate the intention of monetary authorities."

The principal aspects of the Radcliffe-Sayers thesis are:-

(1) Like most other advocates of the new theory of finance, this thesis too accords importance to overall liquidity as the target of monetary action.

(2) The thesis gives due weightage to the role played by NBFIs in affecting the overall liquidity and thereby the demand for goods and services.

(3) Having shifted the importance from 'Supply of money' to 'liquidity', in its view, the latter, instead of the former, should become the centre-piece of monetary action.

(4) Even then, the thesis does not advocate the extension of all the regulatory measures which govern commercial banking, to NBFIs. But it recommends the indirect control of NBFIs through the manipulation of interest-rate structure.

(5) It assigns only a sub-ordinate or emergency role to monetary policy.

2.2.3 J.M. Culbertson and the New Theory of Finance

J.M. Culbertson in his article questions the logical foundations of Gurley-Shaw thesis. He refuses to accept Gurley-Shaw's interpretation of the effects of financial intermediaries and their implications for monetary theory and policy on the ground that the theoretical innovations which support their thesis are not valid. In his opinion, unless their theoretical innovations are correct, their major argument and its important policy implication would be untenable. On the other hand, if their ideas are valid, they call for the wholesale revision of our thinking about monetary theory and economic stabilisation. The principal aim of his article is to substantiate his thesis that the Gurley-Shaw innovations are not valid and therefore their arguments cannot be accepted.

With such an end in view, inter alia, he holds discussion on two main issues which figure significant in Gurley-Shaw thesis. They are:

(1) Do commercial banks differ from financial intermediaries in their ability to create credit in any sense that is significant from the point of view of financial control over the economy?

(2) Application of the Gurley-Shaw theory with specific reference to the long run rate of growth of commercial banks.

29. Ibid., P.119
The theoretical innovations of Gurley and Shaw with regard to the aforesaid issues are not found to be valid in the analysis of Culbertson. Though he considers their innovations to be radical, and if accepted, would warrant a drastic reconstruction of banking theory, debt management theory, financial analysis and the theory of economic stabilisation, he does not consider them to be valid. He asserts, "I cannot however, see that Gurley and Shaw justify their theoretical innovations by the arguments and the facts they adduce." While examining the first issue Culbertson finds that none of the arguments presented by Gurley and Shaw in this regard, is successful to contradict the orthodox doctrine that the commercial banks are unique in their ability to create credit. Hence, he supports the familiar orthodox view that the distinctive properties of commercial banks call for special control over them. Regarding the second issue, Gurley and Shaw argue that the commercial banking system has retrogressed, that banks have lagged behind the pace of general financial development, and they suggest that it is likely to continue in the future. In their view, the retrogression of commercial banking is due to the rapid growth of NBFIs. As such financial control through banks becomes less effective. This is one reason why they advocate the extension of similar controls to other financial institutions. On this, Culbertson says that the argument

30. Ibid., P. 119.
arises out of authors' theoretical innovations rather than new factual discoveries. Culbertson does not accept the functional identity of commercial banks and their demand deposits with NBFIs and their indirect debt, which is the basis for the aforesaid argument of Gurley and Shaw. By doing so, he comes to the conclusion that over a period of time the commercial banks have not retrogressed. He says, "If one argues that commercial banks are functionally identical with financial intermediaries and that demand deposits play the same role in the economy as other types of 'indirect debt', then banks have retrogressed. They have grown less rapidly than some, and total of all, financial intermediaries. On the other hand, if one believes that commercial banks and demand deposits play a unique role in the economy, then they have not retrogressed. In relation to the size of the economy as measured by total outstanding debt or by national product they have maintained or improved their relative position."31

Culbertson's critique of Gurley-Shaw thesis leads to some interesting and intriguing conclusions. It is interesting to note that Culbertson does not argue that the present monetary theory is perfect, that liquidity theory can stand no revision or that the activities of intermediaries are without relevance to the problem of economic stabilisation. Further he admits that financial analysis

31. Ibid., P. 119-38.
must go beyond money supply and take account of changes in the structure of outstanding investment assets— including obligations of intermediaries. On the other hand, it is intriguing to note that he does not accept any of the radical arguments presented by Gurley and Shaw and he does not feel that the Gurley-Shaw thesis is an improvement over the accustomed tools of analysis. To one's astonishment he goes to the extent of saying that the Gurley-Shaw thesis is a step backward.

2.2.4 Robert L. Bennett and the New Theory of Finance

Robert L. Bennett's mature views on the new theory of finance as expounded in his research inquiry are essentially an extension of Gurley-Shaw thesis to the situation obtaining in Mexico between 1945 and 1959 in particular, and that of all the underdeveloped and developing countries in general. Through this research exercise he adds new dimensions to Gurley-Shaw thesis. The most important objective of his study is to outline a theory of the role of financial sector in economic development—a theory which recognises important institutional differences between underdeveloped countries and advanced countries, and between underdeveloped countries today and advanced countries during the early years of their development. In his opinion, Gurley and Shaw's application of the theory has been to an economy at a relatively advanced level of industrialisation rather than to an economy during the early years of a development.

effort. Bennett feels that during the early years of a development effort, it is necessary to place greater emphasis on structural change in both the financial and non-financial sectors. Further, he considers it necessary to place greater emphasis on market imperfections in an economy in which the money and capital markets are relatively underdeveloped.\textsuperscript{33}

To certain extent Bennett follows Gurley and Shaw and then he departs from them. Like Gurley and Shaw, Bennett also analyses the activities of all the financial intermediaries, both bank and non-bank intermediaries. Again, he follows them in considering the liabilities of the financial sector, both money and non-monetary liabilities. But, for the reason that their theory is of particular relevance to the United States economy, he makes a significant departure in his theorising so as to make his theory applicable to underdeveloped and developing countries. He departs in several important respects from the assumptions of Gurley and Shaw. First, as against Gurley and Shaw's explicit assumption of an absence of market imperfections, he emphasises imperfections in the money and capital fund markets; where Gurley and Shaw assume markets quite responsive to changes in interest rates and financial institutions quite efficient in allocating the available loanable funds among alternative demands, he assumes market

\textsuperscript{33} Ibid., PP.VII and VIII.
imperfections and he is forced to give more attention to the particular asset preferences of individual financial intermediaries. Second, Gurley and Shaw discuss the financial sector's activities under several different assumptions as to the degree of control over the financial sector exercised by the financial authorities. Whereas in Bennett's study a financial sector regulated in its entirety by the financial authority is assumed. Based on their assumptions, Gurley and Shaw conclude that the activities of unregulated financial intermediaries necessitate greater restraint imposed by the financial authority on the group of regulated intermediaries. On the other hand, Bennett, by considering a completely regulated financial sector, gives little attention to this aspect of Gurley-Shaw thesis, which has provoked much controversy in the United States. And the final major difference is concerned with the budget restraint of individual financial intermediaries. Gurley and Shaw usually assume that any financial intermediary, other than the central bank, obtains funds only as the non-financial sectors increase their holdings of its liabilities. Thus, in the Gurley and Shaw analysis, the preferences of the public for the liabilities of particular intermediaries together with the reserve requirements and interest rates imposed by the financial authority on these liabilities, determine the quantity of funds allocated by particular intermediaries to the non-financial sectors. Bennett, in his analysis, permits
the central bank and other financial intermediaries to hold as assets the liabilities of other financial intermediaries. Thus, some financial institutions can specialise in receiving funds from the non-financial sectors and other financial institutions can specialise in providing funds to the non-financial sectors. Unlike in U.S.A., he finds in Mexico, the commercial banks' and central bank's holdings of the liabilities of NBFIs are greater than NBFIs holding of deposits. These intermediary funds flows and control of these flows play an important role in his theory of how the financial authority can overcome rather quickly some of the obstacles to development imposed by financial market imperfections.  

Bennett, after pointing out the major difference between his theory and Gurley-Shaw theory, specifies some further institutional conditions explicitly assumed in his model. He assumes that all money is credit money rather than commodity money, and that the central bank provides for an efficient medium of exchange. He also assumes that the central bank provides a secondary market for financial intermediary assets to meet the liquidity needs of the intermediaries.

Bennett, in his modification exercise, in addition to relying heavily on the Gurley-Shaw theory, utilises the

34. Ibid., PP.1-3
Schumpeterian theory of the role of innovation in economic development. In his work, an attempt is made not only to modify and extend the Gurley-Shaw theory of finance to an under-developed economy like Mexico, but the theory so developed is tested with reference to empirical data. From his work we come to know that Gurley-Shaw thesis developed in the institutional background of U.S.A. is of little relevance to the currently underdeveloped and developing countries. And Gurley-Shaw theory need be modified to suit the institutional framework of underdeveloped countries. Thus, the significance of his contribution lies in highlighting the above point and also in providing a modified theory applicable to Mexico and other developing countries, particularly the Latin American countries.

2.2.5 Richard S. Thorn and the New Theory of Finance

In his article, "Non-bank Financial Intermediaries, Credit Expansion and Monetary Policy", Richard S. Thorn, among other things, endeavours to throw a flood of light on one of the vital aspects of the Gurley-Shaw thesis viz., the implications of the growth of NBFIs to the effectiveness of monetary policy. In a way, his article is an exercise in

furthering our understanding of the said issue. To start with, he makes an attempt to clarify the role of NBFIs in the expansion of credit, and examines the manner in which they differ from commercial banks. Like Gurley and Shaw, he does notice that the NBFIs are a potential threat to the effectiveness of monetary policy. But, by exposing us to the subtler aspects of the threat, he makes some meaningful additions to Gurley-Shaw thesis in this regard.

One of the principal conclusions of his inquiry is that any threat which NBFIs may present to the successful implementation of monetary policy lies not so much in their long run secular growth, as in their ability in the short-run to expand credit immune from central bank control. In his analysis, the various financial institutions differ from one another principally in the liquidity of their liabilities and the specialisation of their asset portfolios; they influence not only the amount of credit but also the kind of credit granted. The NBFIs differ from commercial banks in the liquidity of their liabilities and the specialisation of their asset portfolios; and the difference has far-reaching implications for the quantitative and qualitative techniques of credit control employed by the central banks. He says that the growth of the NBFIs relative to the banking system increases the potential ability of the financial system to expand credit. He points out that the

37. Ibid., P.369.
possibility of large interest rate differentials between NBFIs and banks makes the financial system vulnerable to large shifts in deposits from banks to NBFIs, which in turn, lead to expansion in total credit. It is precisely at this point that he widens our understanding of the nature of the threat that the NBFIs pose to monetary policy. In this regard he says that the threat that the growth of the NBFIs may present to the effectiveness of monetary policy lies not so much in the higher credit multiplier of the financial system that results from the more rapid secular growth of the NBFIs relative to the banks, but in the fact that this growth introduces an increasingly important element of credit expansion through a shift in deposits from the banks to the NBFIs.38

As to the imposition of restrictions on the operations of NBFIs, he goes closer to Gurley and Shaw. Monetary policy to be effective need enlarge its scope of operation so as to cover the NBFIs in its regulatory orbit. If the monetary authorities are keen to have the same degree of control over the credit creation activities of the NBFIs as they have over the banks, in his opinion, it is necessary to impose restraints similar to those placed, either by law or by custom, on the loan and deposit rates of interest of banks. And, if equivalent restraints on interest rates are placed on

38. Ibid., P.376.
NBFIs, the danger of sudden shifts in deposits would be removed and the case for NBFIs reserve requirements would lose force. Besides, the narrowing of interest rate differential might affect the secular rate of growth of the NBFIs. This does not mean that he wants to do away with 'reserve requirements'. In the name of uniformity in regulation and to make monetary policy more effective, he recommends for the imposition of 'reserve requirements' on NBFIs at par with commercial banks.

2.2.6 Eugene A. Birnbaum and the New Theory of Finance

Eugene A. Birnbaum's article "The Growth of Financial Intermediaries as a Factor in the Effectiveness of Monetary Policy" is a critical commentary on the role of NBFIs as a factor influencing the effectiveness of the existing instruments of monetary control. He attempts to test the views of Richard S. Thorn and Gurley and Shaw as to the growth of NBFIs and the threat that such growth poses to the effectiveness of monetary policy, with specific reference to the United States. To be more precise, his empirical exercise is directed to find out whether the powers of the Federal Reserve would have to be increased to compensate for any loss presumed to have been a consequence of the growth of NBFIs.

His work does not provide any evidence in support of the widely held view that the growth of NBFIs has narrowed the scope for the effective monetary control by the Federal Reserve Authorities. He says that the growth of uncontrolled financial intermediaries relative to member banks does not appear to have materially weakened the effectiveness of Federal Reserve's Open Market Operations. On the contrary, he says that the growth of uncontrolled intermediaries has helped to promote the development of this instrument of control and probably, even, enhanced its effectiveness.  

2.2.7 M. Madaiah and the New Theory of Finance

Madaiah's doctoral dissertation is an attempt to analyse the situation obtaining in the Indian Economy with reference to two important theses concerning the new theory of finance viz., Gurley-Shaw thesis and Radcliffe-Sayers thesis. In that process, keeping in view the institutional peculiarities of India and that of the objectives of monetary policy, he makes some modifications to the said theses, so that his contribution should be of some use in formulating effective economic policy and monetary policy. He opines that the new theory of finance developed keeping in view the conditions prevailing in the highly developed economies, is not completely and directly applicable to the conditions existing in the developing economy of India.

43. Ibid., P. 401.
45. Ibid., P.183.
He points out that both the theses have stressed on the growth of NBFIs and the problem they have posed for monetary policy as a consequence. He confers on them the credit of breaking a new ground by bringing out the significance of the growth of NBFIs, which had been so long neglected by monetary theorists, and by analysing them from the point of view of the entire financial system as well as from the standpoint of the impact of their growth on commercial banking and monetary policy. On the whole he is of the opinion that the Gurley-Shaw thesis and Radcliffe-Sayers thesis have helped widen our vision in the field of monetary theory and policy, which is indeed a great contribution to the field of monetary economics and economic development.

His inquiry makes it abundantly clear that financial innovations, diversification and proliferation of financial assets have taken place in the Indian economy along with development in real terms. In the Indian case, unlike in the United States and the United Kingdom, Government of India and the Reserve Bank of India, have consciously created certain types of financial intermediaries to meet the developmental needs of the economy. From this angle, his analysis differs from that of Gurley-Shaw's and Radcliffe-Committee's. But in broad terms the Indian financial growth testifies their theses. His analysis shows that the enormous growth of NBFIs and the relative decline of commercial banks have narrowed
down the base for monetary policy in India. In fact, the phenomenal growth of NBFIs has come to threaten the effectiveness of monetary policy. In his view, monetary policy to be effective in realising its objectives of growth with stability, its scope need be widened to embrace all the financial intermediaries—bank and non-bank—on the lines suggested by Gurley and Shaw in United States. However, the proposed policy must take into consideration the peculiar financial structure in India. He suggests that a financial policy of its own has to be framed to regulate and direct the entire financial sector for achieving the objectives of rapid development and relative price stability. He cautions that any attempt to impose vigorous bank-type controls on NBFIs as suggested by Gurley and Shaw, may harm the development of the financial structure of the country. In his opinion, it is necessary to develop a well co-ordinated financial sector to meet the growing needs of the diversified economy. In this direction, he advocates that the RBI should adopt a controlled-Expansionary-Financial-Policy in the place of its present outmoded-controlled-Expansionary-Monetary Policy. He goes further and says that a well co-ordinated-Financial-Fiscal-Physical policy-mix is of vital importance not only to insulate the economy from the inroads of inflationary pressure, but also to aid rapid development.
2.2.8 *Leena Grower and the New Theory of Finance*

Leena Grower's Ph.D. thesis, in a way, is a sequel to Madaiah's doctoral dissertation, as far as the role of NBFIs in the development effort of India and the implications of their rapid growth for commercial banking and monetary policy are concerned. Like Madaiah, she also endeavours to apply Gurley-Shaw thesis and Radcliffe-Sayers thesis to the situation obtaining in India, with the express intention to identify the threat that NBFIs are alleged to pose to commercial banking and central banking. And based on such a study, she intends to indicate the lines on which the monetary authority may reorient its monetary policy to make it effective in attaining the twin objectives of rapid economic development and reasonable price stability. Like most of the principal advocates of the new theory of finance she does observe the distinction between commercial banks and NBFIs. But the way she looks at the distinction leads her to the conclusion that the growth of NBFIs may affect the importance of commercial banking and the effectiveness of monetary policy in the long-run, but not in the short-run. In this regard she observes: "The distinction between banks and NBFIs lies in the different character of their deposit

liabilities. While the demand deposit liabilities of commercial banks are widely accepted as means of payment, the deposit liabilities of NBFIs are not widely accepted as means of payment. Reasonably therefore, commercial banks are termed monetary institutions and NBFIs non-monetary institutions. It is an important feature of our analysis that, while in the long period, the tendency of NBFIs to take up some of the payments functions of commercial banks may reduce the latter's relative importance, it is not a significant factor from the point of view of short period monetary policy." 49

Her study, among other things, reveals that the NBFIs have a definite and determinate role to play in accelerating economic development. She says that the NBFIs supplement the efforts of commercial banks on both the fronts of financial intermediation—deposit mobilisation and lending. She even goes to the extent of stating that the monetary policy in India should encourage the setting up of various NBFIs in the economy and widen and strengthen the scope of their activities. However, she shows her awareness of the possible threat the NBFIs may pose to commercial banks and to the effectiveness of monetary policy, if they remain totally uncontrolled. She asserts that monetary policy need extend the area of its control to cover NBFIs also, if it is to be

49. Ibid., PP. 60-61.
effective, efficient and equitable in its conduct. However, like Madaiah she suggests that if monetary policy is to become a useful and successful policy instrument, it needs to be supplemented with other suitable fiscal and economic policies.

The foregoing discussion of some of the important theoretical works on the role of NBFIs and the implications of their growth for commercial banking and monetary policy, brings out the divergent views that the various advocates of the new theory of finance have on the issue on hand. Most of the theorists agree that the growth of NBFIs is both a cause and consequence of economic development, and most of them agree that their rapid growth may affect the progress of commercial banking and the effectiveness of monetary policy, if they remain totally uncontrolled. However, some writers point out that the new theory of finance associated with the names of Gurley and Shaw need be modified suitably so as to be of use in analysing and understanding the monetary and financial situation obtaining in the underdeveloped and developing countries today. By and large, the writers referred to above, are of the opinion that some kind of control or the other is to be extended to regulate the functioning of NBFIs so as to widen the scope of operation of monetary policy. However, they differ as to the nature and extent of control to be imposed on NBFIs.
2.3 EMPIRICAL STUDIES ON NBFIs

Giving due weightage to the decisive role that NBFIs have come to play in the development process and the threat their growth is likely to pose to commercial banks and central banks, a few empirical studies on NBFIs have been made in the last four decades. A few studies have also been made with specific reference to India and some of the states in India. In view of the little research effort that has gone into the field so far, very little progress seems to have been made to give concrete suggestions to central bankers as to the magnitude of threat the NBFIs pose to both commercial banking and central banking, and as to the nature and extent of control to be imposed on NBFIs. The review that follows includes the empirical inquiries made in highly industrialised economies and developing economies. There are also a few studies pertaining to finance corporations—a popular variant of NBFIs—in South India. Here, it is pertinent to point out that some of the empirical studies, inter alia, are directed to test the Gurley-Shaw thesis and the Radcliffe-Sayers thesis, and some others are not. Even then the latter group of studies give enough statistical information to test the hypotheses.

2.3.1 R.W. Goldsmith's massive work "Financial Intermediaries in the American Economy since 1900" is the

first empirical inquiry into the growing importance of NBFIs in the United States Economy. Goldsmith's work which is based on the data for the period from 1900 to 1952 lends adequate empirical evidence to Gurley-Shaw thesis that commercial banks tend to decline in economic importance relative to other financial intermediaries as countries grow and mature industrially. The study reveals that between 1900 and 1952, the share of commercial banks in the total assets of private financial intermediaries declined from 52.8 per cent to 44.5 per cent. And as percentage of assets of all financial intermediaries, the assets of commercial banks declined from 52.8 per cent to 33.9 per cent during the same period.\footnote{1} Since, the work was not intended to test any well established hypotheses or theses, it does not throw much light on the other aspects of Gurley-Shaw thesis or Radcliffe-Sayers thesis. But its contribution lies in highlighting statistically the significance of NBFIs for commercial banking and monetary policy.

2.3.2 Strictly speaking, Engene A.Birnbaum's article "The Growth of Financial Intermediaries as a factor in the Effectiveness of monetary policy"\footnote{2} is a sequel to R.W. Goldsmith's pioneering empirical inquiry\footnote{3} on NBFIs. In

\begin{itemize}
\item \footnote{1} Ibid., PP.73-85.
\end{itemize}
fact, it is based on the data available in Goldsmith's work.

The primary purpose of Birnbaum's study is to determine, on the basis of available statistical evidence, whether the growth of NBFIs has narrowed the scope for effective monetary control by the Federal Reserve Authorities. It is essentially a study directed to the situation in the United States. The author attempts to find out answer to the question whether the powers of the Federal Reserve would have to be increased to compensate for any loss presumed to have been a consequence of the growth of NBFIs. By converting Goldsmith's data pertaining to commercial banks and NBFIs for the period 1900 to 1952, into bar-diagrams, he arrives at some useful conclusions as to their relative growth in United States. The study substantiates the claims that in the first half of this century, the non-commercial bank intermediaries have grown at a more rapid rate than commercial banks. But, the author says that this relative decline of commercial banks may be a necessary, but certainly, is not a sufficient condition for proving the case that Federal Reserve Authorities are less effective than earlier. In his opinion, while it is true that certain instruments of monetary control most directly affect the member banks of the Federal Reserve System, the Reserve Authorities have another instrument of much broader scope viz., Open Market Operations which may be used to influence the activities of other
financial intermediaries as well as those of member banks.\textsuperscript{54}

The data in Birnbaum's study, no doubt provides evidence to the effect that the uncontrolled intermediaries have been less responsive than member banks to the general requirement of monetary policy, but in his view it does not necessarily imply that the potential effectiveness of monetary policy has been weakened by the more rapid growth of NBFIs. He says that undoubtedly, the evidence is largely a result of the failure of the monetary authorities to exploit the growing power of Open Market Operations as an instrument of control.\textsuperscript{55} On the other hand, his study lends empirical support to the less popular view that the growth of uncontrolled financial intermediaries has been a factor in increasing the effectiveness of Open Market Operations.

2.3.3 Madaiah's doctoral dissertation "Financial Intermediaries, Economic Development and Monetary policy",\textsuperscript{56} is an explicit attempt to test the Gurley-Shaw thesis and the Radcliffe-Sayers thesis in the context of advanced countries like the United States, Canada, Australia and South Africa, and also with special reference to India. Basing his

\textsuperscript{55} Ibid., P.395.
analysis on the data available in Goldsmith's work, he also comes to the conclusion that commercial banks have declined in economic importance since 1900 relative to other financial intermediaries. Further, based on the data available in the Federal Reserve Bulletin, he says that a similar trend continues even beyond 1950s. Between 1946 and 1956, commercial Bank deposits increased by only 38 per cent, whereas the Non-Bank deposits increased by 172 per cent. His empirical inquiry in respect of Canada, Australia and South Africa lends support to the view that commercial banks have declined in economic importance relative to other financial intermediaries. This finding implies that monetary policy to be effective need extend its regulatory net so as to net in NBFIs also.

His empirical inquiry into the comparative growth of commercial banks and NBFIs in India during 1950s and 1960s clearly indicates a considerable growth of deposits outside the commercial banking system. It also shows that the NBFIs have been aggressively competing with banks for deposits by offering higher rates of interest than the banks and such deposits lie outside the direct control of the RBI. This

60. Ibid., PP. 104-118.
finding is indicative of the declining economic importance of commercial banks relative to NBFI.s in the Indian economy. Further, based on empirical facts, he says that the availability of funds from NBFI.s can nullify the effects of restrictive monetary policy and thus defeat the purpose of monetary policy. Based on these findings, he says that it is time for the RBI to consider re-orientation of its monetary policy to make it more effective and meaningful.

2.3.4 Mohandas Saravane's book "Deposits with Non-Banking Companies and Monetary Policy"61 is a useful addition to our knowledge of the growth of NBCs and the impact of their rapid growth on the growth of commercial banking and monetary policy in India. The study is based on secondary data for 1950s and 1960s. Though, he does not explicitly test the Gurley-Shaw thesis or the Radcliffe-Sayers thesis in the Indian context, the study is useful in testing those theses. As to the relative growth of NBs and commercial banks, the study provides conclusive evidence to show that NBs have been growing at a faster rate than the banks, and the trend is suggestive of the threat to commercial banks. According to Saravane, "...if the present disparity in the rate of growth of deposits with banks and with NBs is maintained or is allowed to be maintained, the non-banking companies are likely to emerge as important

61. Saravane, Mohandas, Deposits with Non-Banking Companies and Monetary Policy, Thacker and co. Ltd., Bombay, 1972.
competitors to banks in future in the field of deposit mobilisation from the public. Moreover, to the extent that this type of financing, namely mobilisation of deposits from the public on the part of NBCs is likely to reduce the demand for loans from the banks, the relatively faster growth of deposits with NBCs can be expected to impair the future growth of the banking system not only by reducing their deposit growth but also by weakening the banks' position in their lending activities". As to the basis of competition, the inquiry reveals that the interest rates offered by NBCs are much higher than the deposit rates of banks, and the extent of the spread appears to indicate that enough incentive exists for the public, even after making allowances for risks and the lack of service facilities which the holders of deposits with NBCs have to be put up with, to shift their excess funds to NBCs rather than keeping them in the form of deposits with banks. Above all, the author finds a good number of reasons to justify the imposition of controls by the Reserve Bank over the financial activities of NBCs. Regulations of the deposit-accepting activities of the NBCs are called for out of consideration for the effectiveness of monetary policy and to safeguard the depositors' interest. Of

62. Ibid., PP.21-23
course, indirectly, such controls may even help NBCs in maintaining a sound financial position. Thus, Saravane's study of NBCs provides evidence in favour of Gurley-Shaw thesis.

2.3.5 The Raj Commission Report,63 is an official attempt to examine the relative provisions of the Reserve Bank of India Act, 1934, the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, and the Miscellaneous Non-Banking Companies (Reserve Bank) Directions 1973, with a view to assessing their adequacy in regulating the conduct of business by the non-banking companies covered by the said directions in the context of the monetary and credit policies laid down by the Reserve Bank from time to time, and to suggest measures for further tightening up the provisions so as to ensure that the activities of such companies subserve the national interests and serve more effectively as an adjunct to the regulation of the monetary and credit policies of the country, besides affording a degree of protection to the depositors' monies.64 This empirical investigation which is spread over a period of 9 years from 1963 to 1972 is based on both primary and secondary data.

64. Ibid., PP.2-3.
One of the important findings of the study is related to the relative growth of NBCs and commercial banks. As per the study, the deposits with the NBCs have grown in spite of the fact that there are certain advantages attached to commercial bank deposits which are not available in the other case. The basic reason for the growth of deposits of NBCs is that these companies pay interest rates higher than those paid by commercial banks. In this regard, the Commission feels that the growing volume of deposits with NBCs affects the operation of monetary and credit policy to the extent that it involves loss of direct control on the use of these funds. As such, the current situation calls for a regulation but not prohibition of the acceptance of deposits by NBCs. The Commission by observing the distinction between Non-banking non-financial companies and Non-banking financial companies in NBCs, argues in favour of a selective approach to regulation.

Thus, the foregoing, discussion implicitly suggests that NBCs have been growing at such a rate as to pose a threat to commercial banks, besides restricting the scope and effectiveness of monetary policy.

2.3.6 Leena Grower's Ph.D. thesis\(^6\) is a reasonably

significant empirical exercise to test the Gurley-Shaw thesis and the Radcliffe-Sayers thesis in the Indian context during 1960s and 1970s. The investigation is mostly based on the secondary data found in the various issues of RBI Bulletins. The inquiry provides conclusive evidence in support of Gurley-Shaw's view that the rapid growth of NBFIs relative to the growth of commercial banks, has reduced the economic importance of the latter. In this regard, she says that between 1962 and 1974, deposits with commercial banks showed a little more than five-fold increase, while those with NBFIs showed about ten-fold increase. The study ascribes this situation, among other things, to the relatively higher rates of interest offered by NBFIs. Basing her arguments on the data, she says that NBFIs no doubt compete with banks, but the competition is at the margin and certainly not to the point of causing any significant dent in the business of commercial banks and in the effective working of monetary policy. However, by keeping in view, the credit control burden on banks and the possible threat to the growth of banks in the long-run, she argues in favour of extending RBI's control to NBFIs.

66 Ibid. P. 391.
2.3.7 Probably, C.P.S. Nayar's work "Finance Corporations—A Study of Unregulated Banks" is the first systematic investigation into the diverse facets of the functioning of finance corporations—a significant segment of NBFI s. Spatially speaking, the study covers all the Southern states of Karnataka, Andhra Pradesh, Tamil Nadu and Kerala which have been witnessing a spurt in the growth of finance corporations. The study is based on the data of 1979 for commercial banks and of 1980 for finance corporations.

Some of the principal findings of the study are:–

(a) The finance corporations have been gaining ground in financial intermediation in the Southern States. At the time of the study, the finance corporations mobilised 10 per cent of the deposits of the banks and advanced 12 per cent of the advances of the banks.

(b) The borrowers to whom the cost of credit upto a point is not a major consideration, or those who wish to borrow for purposes not favoured by commercial banks, prefer finance corporations because of the flexibility regarding credit availability.

(c) The fact that the interest is calculated on day to day basis on outstanding loans, and that funds are available almost instantly at any time of the day are

added conveniences which make borrowing from finance corporation attractive.

(d) Depositors too find lending to finance corporations worthwhile inspite of the lack of security because of the high rate of interest. In addition, they enjoy such conveniences as the withdrawal of even term deposits in an emergency without much difficulty and loss of interest, ability to borrow as much as 90 per cent on the security of fixed deposit receipts and easy realisation of matured deposits of a deceased depositor by his heirs.

(e) The administrative expenses form only 1.94 per cent of the deposits of the corporations, whereas they constitute 3.51 per cent of the deposits of banks.

2.3.8 B.A. Prakash's article "Private Financing Firms in Kerala— A Study", 68 is a micro-level empirical inquiry into the origin, growth and functioning of selected private financing firms in Trichur town of Kerala. Temporally, the inquiry is based on the data of February, 1984. The inquiry reveals :-

(a) Since the beginning of the 1980s, there has been a spurt in the growth of private financing firms in Trichur town and as on the date of inquiry more than 1500 firms were engaged in this business. The study attributes this growth to such factors as to the historical background of Trichur town as centre of private financial

and banking institutions, the decline of the private kuri business, the fast expansion of business activities of the town since the mid 1970s, credit restrictions by commercial banks, and accumulation of surplus money with certain sections of the society.

(b) The share contribution of the partners and the deposits obtained from the public are the two principal sources of funds for the firms.

(c) The firms advance two categories of loans viz., block loans and daily repayment loans. Though the firms charge a rate of interest ranging from 39.5 to 42 per cent, there has been a steady increase in the demand for loans.

(d) The firms have emerged as a very powerful parallel banking system in the town posing a threat to the normal banking activities. The firms are able to mobilise very huge amounts as deposits from the public compared to the bank branches in the town. The firms advance loans only to business and other speculative type of activities, and thus in an indirect manner discourage industrial and productive investment. Further, in the process of their functioning they generate and distribute black money.

Considering the decisive role that the private financing firms play in the financial activities of Trichur town, and also of their undesirable effects on the economy, the investigator says that there is a need to regulate the activities of the firms through appropriate regulatory measures.