CHAPTER-I

INSTITUTIONAL FINANCING AND INDUSTRIAL DEVELOPMENT

The problem of financing industries has grown by leaps and bounds, with the result, personal financing of industries, unable to rise up to the occasion has been dethroned from its place of importance and in its place is installed special financial institutions formed with a definite aim to finance and promote new industrial undertakings.

In the developing countries, the prospects for the rapid development of capital market are limited. The volume of private voluntary savings is relatively low to begin with and is at any given income level not likely to be altered significantly by institutional innovations or new savings media. But the proportion of savings that may be redirected to more productive uses in most countries is quite large. The immediate objective of efforts to develop a capital market is to provide the incentives and means for the investment of savings in new ways which will make financing more readily available for productive projects requiring more funds than entrepreneurs can readily provide. The ultimate goal is the expansion of the country's possibilities for self-sustaining economic growth.

In an attempt to increase the industrialization process, virtually all countries of the world, developed and underdeveloped have established special institutions to mobilise their resources of capital and channel them into the productive economy. In the past fifty years the Governments of an increasing number of less developed countries have created, promoted, or encouraged the organisation of entities variously called "development corporations", "development banks", "development finance companies", or "financial intermediaries." These institutions have taken forms so diverse that, despite frequent similarity of formal title, they often have little resemblance to each
other and often have little in common". Such specialized institutions have certain
definite advantages in terms of pooling of resources, diffusion of risks by means
of a diversified investment portfolio, access to expert guidance for
investment, etc.

Financial intermediaries in general play a very important role in the
saving and investment process by raising the level of saving and investment and
allocating more efficiently scarce savings among most productive investment. The
term financial intermediaries is used for those various institutions which collect
savings from others, issuing in return claims against themselves, and use the
funds thus acquired to purchase ownership or debt claims. According to Gurely
and Shaw, "Financial intermediaries are interposed between ultimate borrowers
and lenders to acquire the primary securities of the borrowers and provide other
securities for the portfolios of the lenders. Their revenues accrue mainly from
interest on primary securities and their costs are predominantly interest on
indirect securities and expenses of administering securities". The outstanding
feature of financial intermediaries is that they do not merely mediate but in
the process they can also create higher degrees of safety and liquidity which
are the prime concern of the savers.

Financial intermediaries is a very wide term and covers a wide range
of institutions from simple institution like mutual savings societies, commercial
banks, etc., to highly specialized institutions such as development banks,
insurance companies and investment trusts etc.

Types of Financial Intermediaries

Financial intermediaries are broadly of two types as follows:

(i) Primary financial intermediaries, and

1. Diamond, William, "Development Finance Companies", paper published in the Fund and
Delhi, 1968, p.94.
(ii) Secondary financial intermediaries.

Primary financial intermediaries are those which draw their funds directly from the surplus units—households, business enterprises and Government—and make these funds available to deficit spending units in the economy. Commercial banks, insurance companies, etc. are the main examples of this type.

Secondary financial intermediaries are those which depend for most of their funds on primary financial intermediaries or use their own funds to acquire the securities of primary financial intermediaries. These institutions do not collect funds directly from the general public but act mainly as the lending institutions. Development banks and specialized financial institutions are the examples of this type.

There are some other criteria to make further distinctions among financial intermediaries.

(i) Some intermediaries are privately owned and some are governmental: private commercial banks, credit societies and unions, savings banks, mutual funds, etc., fall in the former category, whereas postal savings system, state owned commercial banks and insurance companies, government pension funds and government specialized financial institutions are the examples of the latter type.

(ii) Some issue a few varieties of debt while others like life insurance companies have a multifarious structure of debts.

(iii) Amongst private intermediaries, some are established for stock holders' profit while others are mutuals or cooperatives.

(iv) Some intermediaries are able to create money and thus in their lending and investment activities they are somewhat free from the limitations imposed by their receipts. Others are not able to do so and hence their
activities are restricted to their own receipts and increase in net worth.

R.W. Goldsmith has given an elaborate list of seventeen different types of financial intermediaries which he has grouped under five different heads as follows:

(i) The banking system,

(ii) Other depository organizations,

(iii) Insurance organizations,

(iv) Other financial intermediaries, and

(v) Personal trust departments.

The first two categories include all those institutions which function primarily as depositories of short-term funds of surplus economic units. The unique feature of the insurance organizations is protection against specific risks. Their liabilities are usually of long-term nature falling due only in accordance with the terms of contract. The fourth category includes those which finance themselves primarily by issuing of their own securities (like investment companies, etc.), those which draw their funds mostly from other financial intermediaries and those which are financed directly by the Government. Personal trust departments are classified separately because they administer assets on the basis of a trustee relationship rather than as debtors or issuers of equity securities.

Functions of Financial Intermediaries

The principal function of financial intermediaries is to purchase primary securities from ultimate borrowers and to issue indirect debt for the portfolios of ultimate lenders. Although primary securities are their principal asset, financial


intermediaries also hold the indirect debt of other intermediaries and own tangible assets as well. Financial intermediaries transform securities into indirect securities which have a constant or determinable redemption value, low investment costs and which are divisible into convenient units from low to high denomination. The reward of intermediaries arises from the difference between the rate of return on primary securities held by the intermediaries and the interest or dividend rate they pay on their indirect debt.

Financial intermediaries exploit the economies of scale in lending and borrowing. On the lending side intermediary can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders. It can schedule maturities so that chances of liquidity crisis are minimum. The mutual and cooperatives are sometimes favoured with tax benefits that are not available to individual savers. On the borrowing side, intermediary with a large number of depositors can normally rely on a predictable schedule of claims for repayments and so can get along with a portfolio that is relatively illiquid. The advantages of large scale borrowings and lendings with numerous creditors and debtors can be distributed to the intermediary's debtors in the form of interest payments and other benefits and to its stock holders in the form of sufficient dividends to attract additional capital funds. Because of economies of scale, the assets and liabilities of financial institutions are highly specialized.

Highly organized security markets greatly increase the speed and economy of transactions in securities. Securities can be bought and sold quickly and with an increasing degree of their marketability, liquidity is also increased. Financial intermediaries increase the liquidity of securities by lending on them. In fact financial intermediaries manufacture the liquidity. They create claims which are more liquid than the securities they buy, and issue them to savers. Thus, more savings are canalized into investment activity.

5. Gurely and Shaw, op.cit, p. 192.
In underdeveloped countries, savings are institution elastic. They respond readily to the stimulus of new savings facilities provided by financial institutions. A variegated structure of financial intermediaries can appeal to the security, motivation and other such aspects of savers and attract more savings by creation of an array of attractive financial assets. This increases the volume of savings in the economy and affects its direction.

Financial intermediaries are better placed than individuals to channel the funds into investments in the priority areas which will accelerate the rate of industrial development. Savings of an individual firm or producer may not be large enough to start new projects in other areas which are needed most in an underdeveloped country, and hence they may be employed in the same industry at a diminishing rate of return. Financial intermediaries, in this case can mop-up the scattered savings successfully and allocate them in such a manner that it would promote maximum increase of output in the economy.

Financial intermediaries can help to a large extent in removing sectoral imbalances among various industries by making more funds available to less developed sectors at lower rates of interest and discriminating against the developed sectors of the economy. Government financial institutions play very important role in this field. Financial intermediaries can make significant contribution towards modernization, rationalization and rehabilitation of industries. The financial intermediaries can also facilitate the expansion of markets through distributive techniques.

Specialized financial institutions also enable the entrepreneurs to import capital goods and machinery and know-how from abroad by providing the scarce foreign exchange.

Apart from these traditional functions, specialized financial institutions have also undertaken a number of promotional functions like guidance and technical assistance in project identification, formulation and implementation,
development and broad-basing entrepreneurship, upgrading managerial skills etc. Foreign technical collaboration or advice and services of experts can be obtained in the best possible manner through specialized institutions.

Finance constitutes an important limitation to the whole process of industrialization and financial intermediaries apart from mobilizing domestic resources can also obtain funds from foreign countries as loans or by issuing of bonds etc. For individual producers it may not be possible.

Financial Intermediaries and Industrial Development

The process of economic development requires, as one of its accompanying structural changes in the economy, the development of a capital market which will provide an adequate and properly distributed supply of finance to the entrepreneurs setting up new industrial plants or thinking of expanding or modernizing the already established one. While finance itself produces no output, but it enables the entrepreneurs to gain control over real resources which enable them to engage in industry by producing and distributing industrial products. At an early stage of development, the would-be entrepreneurs normally find their own financial resources inadequate and must resort to external sources. Such finances are made available by financial intermediaries.

The adequate capital formation is sin-qua-non for speedy industrial development. The process of capital formation involves three distinct, although inter-related activities.

(a) Savings, the ability by which claims to resources are set aside and so become available for other purposes.

(b) Finance, the activity by which claims to resources are either assembled from those released by domestic savings or obtained from abroad or


specially created as bank deposits or notes and then placed in the hands of investors.

(c) Investment, the activity by which resources are committed to production.

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. Financial intermediaries help to promote these activities.

In the process of capital formation financial intermediaries, help not only in effective mobilization of savings from a large number of scattered masses and canalization of these savings into the most desirable and productive forms of investment but also affect the growth of real savings through their numerical spread over sections of population approached, accessibility, popularity, nature and extent of facilities offered and the rate of interest paid on deposits. The financial intermediaries, thus, help to promote the process of capital formation by bringing together the supply of savings and demand for investable funds.

In a modern economy which is characterized by money exchange, the bulk of the investors are business firms, while the primary savers are the households. Business firms desiring funds for investment can and do borrow some of what they need directly from savers by selling to them stocks and bonds, but many savers are unwilling to lend their money directly to business in exchange for these types of financial claims. In such a situation some intermediary is needed to bring the deficit and surplus units together. Indeed this is the prime role of financial intermediaries.

Financial intermediaries not only help in mobilization and collection of scattered savings from different sections of population, but they also help to increase the overall level of savings and investment and allocate more

efficiently scarce savings among most desirable and productive investments in accordance with the national priorities.

There is another important angle to the role of financial intermediaries in industrial development, particularly of banks, which have been popularized by distinguish economists like Schumpeter, Kalecki and Keynes. To Schumpeter, bank credit plays a critical role in stimulating industrial development. According to him, "created credit" enables an entrepreneur to proceed with his innovation in anticipation of savings. He wrote, "the banker, therefore, is not so much primarily a middleman in the commodity "purchasing power", as a producer of this commodity". Newly created purchasing power by banks placed in the hands of the entrepreneur enables him to secure command over physical resources and thus push through his investment projects. Once the investment results in the increased production, the initial credit inflation disappears and the equivalence between money and commodities streams is restored. Both Kalecki and Keynes regarded the availability of finance as a key factor in ensuring independence of investment from savings. Schumpeter had vehemently emphasized the crucial role of credit institutions in the financing of innovations and thus facilitating industrial development.

Besides performing the financial functions, financial intermediaries also provide entrepreneurial assistance to the loanee concerns/individual entrepreneurs/projects, act as an agency for securing foreign technical advice, and raising funds from the capital markets of advanced countries. The intermediaries also facilitate the expansion of markets through distributive techniques and undertake other promotional jobs of an essential nature, such as, marketing and investment research surveys, technoeconomic feasibility and cost-benefit studies of different growth sectors or a region, particularly the backward regions of the country so as to identify potential for industrial growth.

Adequate financial resources are vital for increasing the pace of industrialization and therefore, the existence of suitable agencies to mobilize and develop resources that are internally available becomes necessary. It is at this stage financial intermediaries come into picture. While the financial intermediaries can not be an engine of growth, but they can certainly act as a growth inducing factor in desirable directions.

In a rudimentary economy, where there are no financial intermediaries, there are restrains on savings, on capital accumulation and on efficient allocation of savings to investment. These factors act as an impediment to the growth of output and income. This is true for developing countries where financial system is generally immature and therefore, acts as an obstacle to industrial growth. In a developed financial system, the efficient operation of specialized financial institutions can raise the savings and investment above the level that would have occurred had there been no such institutions. In addition, by bringing about a better allocation of investment, the productivity of capital is improved and this promotes the 'real' economic growth of the country.

In developing countries, availability of finance is one of the important bottlenecks in the process of rapid economic development. Since personal savings are meager due to lower per capita income in these countries, the chances of increasing the rate of savings appear to be poor. However, much can be done by putting greater emphasis on institutionalization of savings. Therefore, one of the most pressing needs of the developing countries is to promote financial integrity, effective and cheap protection for rights of creditors and create financial institutions through which the savings of the community can be increased and effectively channeled into the hands of investors.

In the developing countries, institutional arrangements for the mobilization and channelling of financial resources must be continuously expanded.

and adopted to the growing and varied needs of the economy. Even in developed countries the need for specialized financial institutions is being increasingly felt, though the quantum of assistance channeled through them is small in relation to what is provided by the ordinary capital market mechanism. In developing countries the need for such institutions is much greater and in this connection, a great deal of initiative and assistance is called by the Government and its agencies.