Economic development is influenced by basic factors of physical, technological and psychological nature. It is not possible to measure the role of each factor separately. Moreover, the influence of forces like financial intermediaries cannot be easily measured. But as countries rise along the scale of wealth and income, their financial structures usually become increasingly rich in financial assets, institutions and markets. It indicates that financial development takes place along with real development.

An attempt is made in this chapter to provide an introductory note on the role of money and finance in economic activity in the historical perspective followed by an attempt to explain the methodology and significance of the present study and the plan of the study.
Money and Economic Activity

The role of money and finance in economic activity has been a matter of considerable controversy among economists. Economists have been largely pre-occupied with markets for current output, real wealth and labour services. They have put relatively little effort into working out conditions of supply and demand in financial markets. The works on money and banking and on monetary theory have paid insufficient attention to finance in the broad sense. They have made little attempt to deal in any systematic way with financial assets, financial institutions and financial policy generally.

The classical economists, on the whole did not place much emphasis on the role of money in determining the course of economic activity. They were inclined to think that money was a 'veil' and it did not affect real quantities such as savings, investment, the rate of interest and the volume of output. The reason for this is that money being only useful for exchanges of goods, a larger quantity does not, as with other things, carry more satisfaction on its back than the smaller quantity. The institution of money is a powerful instrument promoting wealth and welfare. But the number of units of money embodied in that
instrument is, in general, of no significance. All changes which occur in the money garment result from changes initiated in the body, and these changes in the garment do not react in any way on the body.

The quantity theory asserts strict proportionality between the quantity of money and the level of prices.

Thus, money in the classical tradition was treated as neutral so far as real economic relations were concerned. Changes in the quantity of money induced changes only in the general price level so that price ratios remained unaffected. Relative price changes were attributed to real factors.

In the classical tradition money was a passive factor in the basic functioning of the economic system. Its effect was felt on the general level of prices alone and this was the chief reason why it was regarded as unimportant.

There is a serious flaw in this argument. As a case in point, consider the celebrated classical and neoclassical doctrine of forced saving. The essence of this doctrine is that an exogeneous increase in the quantity of money which accrues initially to entrepreneurs or to those who lend to them, will increase the proportion of an economy's expenditures going into investment, and that the necessary corresponding increase in savings will be forced upon
workers and fixed income recipients by the inflationary price movements which the monetary expansion generates. Such an expansion can increase the amount of real capital in the economy. It is but a special case of general awareness of classical economists that a monetary increase can not be neutral in its effects unless it is initially distributed among all members of the economy in a uniform way.  

The credit for bringing money as a factor in economic analysis belongs to Keynes. The fundamental contention of Keynesian monetary theory is that a monetary economy is essentially different from a barter economy - that money is not merely a veil but it exercises an influence of its own in the working of the economy. In Keynes' theory money is an asset and bonds are substitutes of money. Thus, if there is an excess supply of money, there will be an excess demand for bonds resulting in a rise in bond prices and a fall in the rate of interest. When there is a change in money supply, the public will have to adjust their asset portfolio consisting of money and bonds in this simple two asset model. The public may be willing to make this relative asset substitution if only the return on bonds will change.
The Keynesian liquidity preference model embraces a time period that current expenditure including investment cannot lead to an increase in wealth or direct debt. The model appears to exclude borrowing, so that loanable funds cannot flow and cannot affect the rate of interest. In Keynesian dogma, the rate of interest does depend on past flows of loanable funds, however, the current flows are not able to significantly influence much. Past flows have left the heritage of a stock of direct debt or bonds. The distribution of past flows between direct channels of finance and one indirect channel, the monetary system, has affected the allocation of bonds between spending units and the monetary system, and as a result, the proportion of bonds to money in the portfolios of spending units.

The post war period has also seen a return to analysis in terms of quantity theory accompanied by a reformulation of the quantity theory. The reformulation is contained in the restatement of the quantity theory by Milton Friedman in "The Quantity Theory of Money - A Restatement".

The central point in the restatement is that the quantity theory is a theory of demand for money, not of output, money income, or prices, and that money is an asset or capital good, so that the demand for it is a problem in
capital theory. In formulating the demand for money as a form of capital, however, Friedman differs from the Keynesian theorists in starting from the fundamentals of capital theory. Friedman begins with the broad concept of wealth as comprising of all sources of income, including human beings, and relates the demand for money to wealth and expected further streams of money income obtainable by holding wealth in alternative forms.  

Friedman's application to monetary theory of the basic principle of capital theory is probably the most important development in monetary theory since Keynes' General Theory. Its theoretical significance lies in the conceptual integration of wealth and income as influences on behaviour. Keynes ignored almost completely the influence of wealth as was legitimate in short period analysis, and while subsequent writers in the Keynesian tradition have reintroduced wealth they have generally followed the Cambridge practice of restricting wealth to nonhuman property. In consequence much of the recent monetary literature contains formulations of the demand for money relating it to income, wealth and rate of interest.

Monetary Theory and Financial Theory.

Keynes analysed the demand for money in relation to demand for bonds. The logical extension of this analysis
would be to consider a variety of assets possessing varying degrees of liquidity and maturity. The analysis extends to the demand for and supply of the whole spectrum of financial assets rather than just the demand and supply of money. The institutions such as the Government, banks and other financial institutions are suppliers of financial claims for the public to hold. The demand for these assets by the public is analysed by the portfolio balance approach. In this context it is more appropriate to consider and to formulate monetary theory as a part of more general theory of asset holding. In other words it is inappropriate in the present macro-financial context to consider monetary theory in terms of money alone. In the context of financial developments it would be in the fitness of things to analyse the monetary phenomenon in the context of general financial developments.

Financial Aspects of Development

One of the paradoxical features of the economics of development is that despite the immense proliferation of literature on the subject, inadequate attention has been paid on the monetary and financial aspects of the growth process and the role of money in development and planning.

Professor Schumpeter made credit creation by banks an integral part of a development process and regarded the
banking system, along with entrepreneurship as being the key agent in the process of development. The entrepreneur secures the funds for his project not from saving out of current income but from the credit creating banking system. The credit creating facilities tend to free investors from the voluntary abstinence of savers. Forced savings become the important means of capital accumulation.  

Gurley and Shaw provided an elaboration of the role of financial intermediation and the related aspect of widening the spectrum of financial assets available to the community in the process of development. Development involves finance as well as goods. In this sense, though the basic determinants of economic development may be outside the financial system the latter influences the pace of development in the manner and to the extent to which it performs the role of intermediation between the saver and investor.

Neglect of Financial Aspects.

The neglect of the monetary and financial aspects of development is attributable to a variety of influences. It is due to the planners' presumption that money is not a limiting factor in economic development, a standpoint rendered plausible by the tendency of economic theory to regard money as a passive variable since it does not
absorb real resources, is infinitely elastic in the supply and can be adapted to the requirements of the real variables of the economic system.  

Though the ultimate determinants of economic development are real factors, it does not, however, prove that monetary factors cease to be important or relevant for the growth process.

The role of monetary and financial policy in a developing economy is broadly: (a) to provide for the optimum supply of money in consonance with the requirements of economic growth, (b) to ensure that finance is available at reasonable cost to essential and strategic sectors in the economy and (c) to create and maintain an adequate institutional framework to fulfill these objectives. A developing economy means rising output over time and this in turn necessitates expansion in money supply. Firstly, because as national income increases the demand for money (transaction balances) increases, secondly, the monetisation of the subsistence sector in the economy also requires additional money, and thirdly, as per capita real income rises, the demand for precautionary and speculative cash balances also tends to increase, although not necessarily in proportion.
Financial development and economic development are interdependent and therefore, a sophisticated financial system is essential for economic development. In a developing economy, an underdeveloped financial system acts as a constraint to economic growth. In the absence of financial assets other than money, there are restraints on saving, on capital formation and on efficient allocation of savings for investment. The developed financial system can stimulate saving and investment and promote real economic growth.

A financial system has three dimensions (i) the institutional financial structure, (ii) the financial asset structure, and (iii) the yield structure. Saving-Investment Process is highly disintegrated one, in the sense that the savers are very large in number and diffused and the users are comparatively few. Effective mobilisation of savings for economic development requires institutional intermediation between the savers and investors. A variegated institutional financial structure would help saving-investment process by offering different maturities and yields by financial institutions.

The whole issue of the relation of financial intermediation to economic development should be studied under
the three heads, viz., the institutional financial inter-
mediation, the asset intermediation and the yield structure.

Methodology.

Since this is the macro study, it is rather not possible
for an individual researcher to collect primary data on an
all India level. The present study is therefore, based on
the secondary or documentary data available from the various
publications especially official. The available informations
are statistically presented in the Tables/Statements for the
purpose of analysis.

The financial institutions are of different varieties.
As for instance, there are all India financial institutions
and State level financial institutions. It is not the object
of this study to analyse the financial operations of a partic-
cular institution. The approach is essentially aggregative.
The aggregative role of these institutions is broadly classi-
fied into quantitative aspects and qualitative aspect. The
role of commercial banks as financial intermediaries is
treated separately.

In the case of asset intermediation, an attempt is made
to throw light on the asset preferences of the household
sector as the savings of this sector are predominant in the
domestic saving structure.
Significance of the Study

After the nationalisation of 14 commercial banks in July 1969, there is a significant change in the banking policies in the country. A phenomenal drive has been witnessed for branch expansion in the rural and unbanked areas of the country. The advances of the banks have also increased to the hitherto neglected sectors. This has also significant impact on the deposit mobilization. The Regional Rural Banks are being set up under the RRBs Act. The operations of the term financial institutions have also expanded during the 70s.

All these factors have significant bearing on the financial structure and financial development of the country. The period selected for the present study viz., the period of the 70s is relevant in this context.

Some attempts have been made earlier to throw some light in this area, but the studies have either concentrated on institutions, or assets or yields taken separately. All these aspects are interrelated, and form the parts of a single process, viz., financial intermediation. The present study is an attempt to examine this process in its tridimensional significance.
Plan of the Study

The present study comprehends eleven chapters including the present one.

Chapter II presents the role of financial intermediaries in the saving investment process. An attempt is made here to bring out the importance of financial intermediation in economic development. The argumentation deals with the developments in the theory of finance.

Chapter III deals with the theory of development banking. In a developing economy the demand for industrial finance particularly for the medium and long term is increasing by leaps and bounds. To meet this requirement proliferation of financial institutions has taken place. These institutions have to discharge the responsibilities of development banking. In this context it is worthwhile to present analytical discussion on the theory of development banking.

Chapter IV attempts to present a synoptic review of the evolution of development banking in India. The Government has initiated the setting up of development banks in India either at the all India level or at the State level.

Chapter V attempts to present the aggregative role of development banks in India. Their operations have been
classified into quantitative and qualitative or promotional aspects. It is not the object of the present study to examine the role of each financial institution separately.

Chapter VI deals with the Banks as financial intermediaries. Banks being the oldest financial intermediaries have acquired much significance in recent years particularly after nationalisation of the 14 major banks in July 1969. Their operational policies have changed. They are not only financial intermediaries in the true sense of the term but are also assigned the developmental role in recent years. All these aspects are elaborated in this chapter.

Chapter VII examines the working of the Regional Rural Banks (RRBs) which are the recent addition in the institutional structure in India. RRBs are meant to fill in the institutional gap in the rural areas. A separate chapter can well provide the scope for elaboration on this aspect of the financial structure.

Chapter VIII deals with a cognate aspect of financial intermediation viz. the asset intermediation. Not a single financial asset such as money but a variety of financial assets are necessary to satisfy the portfolio preferences of the savers. Household sector being a dominant sector in the domestic saving structure of the country, the study of asset preferences of this sector becomes very much
significant. An attempt has been made here to examine the asset preference structure of the household sector.

Chapter IX deals with the third aspect of financial intermediation viz., the yield structure. Yield rate is also an important aspect of financial intermediation. In the economy there is not a single rate but a spectrum of interest rates. Each rate has its own characteristics. The behaviour of interest rates in India is examined here.

Chapter X deals with nonbank financial intermediaries. With the development of the economy the institutional financial structure becomes more diversified. In recent years the financial intermediaries popularly known as nonbank financial intermediaries (NBFIs) have developed. They compete with banks in their business. In other countries they have developed outside the ambit of the central bank but in India this is not the case. An attempt is made in this chapter to examine the growth of NBFIs in India and the policy measures taken by the Government/Reserve Bank of India to regulate them.

Chapter XI attempts to highlight the important observations and conclusions emerging from the earlier discussions.
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