Financial growth and economic growth are interdependent. Finance as one of the important inputs is greatly required to feed the process of capital formation and in turn economic development. Financial intermediation between Ultimate Lenders (ULs) and Ultimate Borrowers (UBs) for the mobilisation and channelisation of savings is an economic necessity for economic development. The financial intermediaries interpose themselves between ULs and UBs in order to translate savings into investment necessary to keep production process operating. An attempt is made in this
chapter to analyse how the financial intermediaries counting in the saving-investment process (SIP) and economic development.

The Role of Surplus and Capital in Economic Development.

The process of economic development is highly complex phenomenon and is influenced by numerous and varied factors. According to Ragnar Nurkse economic development has much to do with human endowments, social attitudes, political conditions and historical accidents. Capital is a necessary but not a sufficient condition of the progress.1

From the standpoint of economic analysis the three most important factors determining the rate of economic development are:

(a) Rate of capital formation.
(b) Capital output ratio, and
(c) The rate of growth of population.

The crux of the problem of economic development in an underdeveloped economy lies in a rapid expansion of the rate of its capital investment so that it attains a rate of growth of output which exceeds the rate of growth of population by a significant margin.2
Professor H.W. Singer has visualized the process of economic growth in terms of the following determinants.

\[ D = SP - r \]

where \( D \) = Rate of economic development, \( S \) = The rate of net saving, \( P \) = Productivity of new investment per unit of capital, \( r \) = The rate of annual increase of population.

Capital formation is the most crucial and strategic determinant of economic growth, though there are other factors too having a bearing on growth. The rate of capital formation depends on the rate of saving and investment. Financial development plays a crucial role in the SIP. Financial development consists in the development of financial assets, institutions and markets.

Economic development is usually discussed in terms of 'goods' aspects such as output, income, wealth etc. Financial aspects of economic development are comparatively neglected. There has not been done any co-ordination of these two aspects and economists seem to have under-valued the role that finance plays in determining the pace and pattern of growth. Development is associated with the debt issue 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, change in market prices of financial claims and in other terms of trading in loanable funds.  

In underdeveloped countries non-availability of finance is an important obstacle in the process of economic development. As these countries account for low per capita income and meagre savings the chances of increasing the rate of saving appears poor. However, this position of the economy can be significantly improved by erecting financial net work for mobilization of idle saving. Thus institutionalisation of saving is essential for promoting investment activities.

The most urgent need of the underdeveloped countries is to promote financial integrity, establish effective and chief protection for the rights of creditors and create the financial institutions through which savings of the community can be effectively channelised into the hands of active investors. 

This emphasises the role of finance in the process of economic development. In a rapid growth of asset formation the internal finance as well as direct external finance falls short of the increasing capital requirements and hence indirect external finance which is supplied by
financial intermediaries acquire considerable importance. The study of financial intermediaries, which help in raising the level of saving and investment and in allocating more effectively scarce resources among alternative opportunities, becomes an important part of the study of economic development. In this context it will be necessary to discuss briefly the nature of spending units.

**Spending Units.**

Spending units can be classified into three categories:

1) Balanced budget spenders
2) Surplus budget spenders
3) Deficit budget spenders

Spending units with balanced budget keep their spending precisely in balance with their income. Their investment will be equal to savings so that their financial assets do not change relatively to their outstanding debt. In the case of these units all expenditures are financed internally.

Spending units with surplus budget will have an excess of income over spending on goods and services. If they save, their saving exceed their own investment. They are the suppliers of loanable funds. Their financial assets increase more than their liabilities.
Spending units with deficit budget permits spending to exceed over their income. Their financial liabilities exceed their assets. They are the demanders of loanable funds by issuing financial claims or debt instruments.

The budgetary imbalances normally lead to net issue of primary securities and net accumulation of financial assets. This is important because the existence of financial assets in an economy presupposes that at least some economic units are not financially self-sufficient. The basic fact that some units are deficit units or excess spending units and some units are surplus units or under spending units generates the need for borrowing and lending. A borrower acquires funds by issuing a debt instrument or a claim against himself. This debt instrument is a financial instrument for the lenders. The exchange of funds between lenders and borrowers may be done either directly or indirectly through the financial intermediaries. The financial intermediaries have a common, basic function which is to stand in between those who wish to lend and those who wish to borrow, or in the terminology used above to stand in between those with budget surpluses and those who wish to run budget deficits. The figure below illustrates these possibilities.
Figure 1

(a) Direct Financing

Financial Resources

Ultimate Lender

Ultimate Borrower

Sale of Primary Securities

(b) Indirect Financing

Financial Resources

Ultimate Lender

Financial Intermediary

Financial Resources

Ultimate Borrower

Obligations of Financial Intermediary

Sale of Primary Securities
Part (a) of the figure - 1 shows a situation where a financial intermediary does not enter the relationship between the borrower and the lender. In this case there is a direct flow of funds between those with surpluses i.e. lenders and those intending to run deficits i.e. borrowers. This may be termed as direct external financing. In part (b) of the figure the UL does not provide funds directly to the UB but places funds with a financial intermediary and in return has a claim on the financial intermediary. Having received the funds from the UL the financial intermediary is capable of on-lending such funds to the UB who in turn provides primary securities which are held by the financial intermediary. 

In this theoretical frame ULs or under-spending units have to take a decision that out of total saving, how much is to be used to purchase primary securities of UBs or overspending units and how much is to be used to purchase claims on financial intermediaries. 

Suppose in a given period total volume of saving is equal to S. Suppose the ULs purchase primary securities worth $P_1$ from UBs and FA amount of debt created by financial intermediaries. Then,

$$ S = P_1 + FA \ldots \ldots \ldots \ldots (1) $$
Now assume that financial intermediaries purchase $P_2$ amount of primary securities from UBs. Under the assumption the total investment ($I$) is equal to

$$ I = P_1 + P_2 \quad \ldots \ldots \ldots \ldots \quad (2) $$

Since ex-post $S$ and $I$ must be equal, it follows that

$$ FA = P_2 $$

The total value of assets created by the financial intermediaries is equal to the total value of assets purchased by them. The total value of financial assets created in the economy is equal to $P_1 + P_2 + FA$. The total value of $S$ and $I$ is equal to $P_1 + P_2$. Thus the total value of financial assets created during a period is not equal to total saving. Due to the role of financial intermediaries, the value of financial assets created is larger than the quantum of saving and investment. This conclusion is useful in the context of a popular misunderstanding that deposit expansion may be identified as savings. There may be a relationship between growth of financial assets and saving. Although the two of them are certainly not identically equal. 10

**Financial Intermediaries and Financial Assets.**

The prime function of financial intermediaries is to purchase primary securities from UBs and to issue indirect debt for the portfolios of ULs. Although primary securities are
transactions are interdependent. Direction transactions between ULs and UBs on the one hand are constrained by lack of knowledge about available opportunities and the fact that direct transfers are likely to be inconvenient, expensive, risky and ineffective as a means of promoting the flow of savings into investment. The financial intermediaries offer their own debt to ULs in exchange for money and as a separate transaction lends money to UBs in exchange for their primary securities. The debt issued by the financial intermediary is known as indirect security. These indirect securities are acquired by the ULs instead of primary securities. The surplus units can, therefore, choose between various types of primary securities and indirect securities.

The product of intermediation is thus, the indirect financial assets coined from the underlying primary securities. The reward of intermediation arises from the difference between the rate of return on primary securities held by the intermediaries and the interest rate they pay on their indirect debts. This indicates that the holders of indirect securities receive less income than they would obtain if they held primary securities or real assets directly. There must be some compensating advantages that surplus units derive in holding indirect securities rather than primary securities. They are:
1) **Indirect securities are relatively more liquid than primary securities.** For example, saving deposits can be withdrawn at short notice whereas mortgages or shares can not readily be converted into cash in the short run without involving losses. That the liabilities intermediaries create are more liquid than the assets they hold.

2) **Investment in indirect securities are immune from capital losses and thereby assure safety of the amount invested.**

3) The unit of investment or disinvestment in indirect securities often is composed of small denominations while this is not possible in the case of primary securities. Thus, an individual can not sell half of a mortgage but he can withdraw half of the saving deposit.

4) **Investment in indirect securities is much easier and less risky as compared to direct investment in primary securities.** The latter involves a certain amount of expertise if it is to be relatively rewarding.12

**Economies of Scale.**

Financial intermediaries are in a better position to exploit economies of scale in lending and borrowing operations. The very magnitude of financial intermediary
portfolio permits a significant reduction in total risk through diversification not available to household lenders. Individual households generally do not have expertise, time and skill to manage their portfolio so as to attain efficient set of risk-return opportunities from wealth ownership. The specialisation of intermediary operation permits administrative economy and expertise in the negotiation, appraisal service, accounting and collection of assets and liabilities which, due to large fixed costs involved, remain beyond the reach of the individual UL.13

On the lending side, the intermediary can invest and manage investments in primary securities at unit costs for below the experience of most individual lenders. On the borrowing side, the intermediary with a large number of depositors can normally rely on predictable schedule of claims for repayment and so can get along with a portfolio, that is, relatively illiquid. The advantages of large-scale borrowing and lending with numerous creditors and debtors can be distributed to the intermediary's debtors in the form of favourable terms of lending to its creditors 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 the economies of scale are important, the assets and particularly the
liabilities of financial intermediaries are highly specialized. They can schedule irregular time-shape of future individual claims into predictable time distribution of aggregate cash inflows and outflows so as to minimise the chances of liquidity crisis.

There are other external economies associated with the growth of financial intermediaries. External economies are particularly evident and important in the case of the monetary system. An efficient monetary system is an essential condition for real growth in the community. 14

Financial Techniques.

The transfer of loanable funds between ULs and UBs in the initial stages of development in an underdeveloped economy in which the sophisticated financial structure is absent takes place through personal negotiation. But at a later stage of development the importance of such direct transactions for loanable funds gradually declines and the development of financial techniques creates alternatives to personal negotiation technique.

There are two main types of financial techniques.

1) Distributive techniques.

2) Intermediary techniques.
The distributive techniques increase the efficiency of markets on which UBs sell and ULs buy primary securities. They include the dissemination of information to UBs regarding the asset preferences of ULs and to ULs regarding the issues of borrowers. They include the widespread network of communications that tend to overcome regional market barriers. Facilities for brokerage, for market support and seasoning of new issues, for future as well as spot deliveries are also distributive techniques.15

Distributive techniques promote flexibility of security price and increase the competitiveness of security markets. Facilities of wider security market enable borrowers and lenders a higher degree of diversification in their debt or financial assets. With a diversified portfolio, an investor can obtain more liquidity, more safety and more gains. Such techniques bring down the demand of investors for other alternatives of primary securities and particularly money. They increase the breadth of the market for loanable funds.

Intermediary techniques bring financial institutions into the bidding for primary securities and substitute indirect financial assets for primary securities into the portfolio of ULs. The financial intermediaries thus do not merely perform the job of mediation but they also transform the heterogeneous issues of small borrowers into homogeneous,
standardized form of marketable security. The financial intermediaries remove the geographical barriers in the movement of funds. They can exploit economies of scale and opportunities for arbitrage, and increase the returns of their creditors. They can also reduce the regional differences in primary securities and interest rates.16

SIP and Economic Development.

As stated earlier capital formation is the main key to economic development. The process of capital formation involves three interdependent stages, viz., (a) an increase in the volume of real saving which depends upon the will to save and the capacity to save, (b) the existence of credit and financial institutions to mobilise and canalise these savings for converting them into investible funds, (c) the use of savings for purposes of investment in capital goods.

Capital formation thus depends upon SIP. The financial intermediaries can influence this process to a great extent and therefore it would be more appropriate here to discuss the SIP and economic development.

The crucial role of saving in economic development was well recognised by classical economists and was reflected in Adam Smith's argument in his well known book - "Wealth of Nations" which stated that national economic progress
consists not in the accumulation of gold and silver but in
the increasing productivity of a country's people brought
about largely by the accumulation of capital in the form of
machinery and other productive equipment. In the neo-
classical view, an increase in the supply of saving stimulates
capital accumulation by causing the rate of interest to fall.
Consumption and investment are considered as exhaustive
alternative uses of income; and capital formation at any given
time directly varies with the ability and willingness to save.
Both the classicals and neo-classicals regard saving and
investment as interest elastic. The ex-post SI equality will
be brought about by the changes in the rate of interest. They
have taken income as given under full-employment situation.

Keynes has emphasized store of value aspect of the demand
for money i.e., speculative demand for money. The aggregate
demand for money 'M' is equal to $M_T + M_L$. The subscripts T
and L denote transaction (including precautionary) and
speculative demand for money. $M_L$ according to Keynes is
interest elastic. There is a high range of interest rates
in which speculative demand is zero. The practical conclusions
from the Keynesian argument are that saving promotes capital
formation in conditions of full-employment or, short of
full-employment, when the net speculative demand for money
is zero. In other conditions saving is probably, but not
necessarily a depressant to investment. The important point
to note is that the Keynesian analysis is short term
oriented and fails to consider secular relations of SI
propensities. SI usually involves three inter-related parts; (a) an act of saving (b) a process of transferring money savings from the surplus units to deficit units and (c) an act of spending for output to maintain or increase the stock of capital goods.

If any one part of these three parts is missing, it can interrupt investment and thereby economic growth.

Mobilisation of saving comprises of several processes. Such as (a) the accumulation and dissemination of knowledge and (b) the development of facilities for transferring savings over wide geographical areas.

Funds obviously can not flow into their most productive uses if the suppliers of loanable funds are ignorant about the available alternatives in which they put their surpluses. Moreover the capacity of the households themselves is limited to collect such informations. To function satisfactorily, therefore, a financial market is indispensable for collecting related informations regarding the availability of investment opportunities and dissemination of thus collected informations amongst the decision makers and put the same to effective use.

All the suppliers of loanable funds do not possess the training, inclination or time to effectuate such informations.
The surplus units can transfer their surpluses to the financial intermediaries, whose very size enables to collect more information to use it more effectively.

One of the serious bottlenecks in the mobilisation of savings is that, the country is divided into many regional markets with no inter-connections. What is pertinent is some sort of a nation wide market on which suppliers of saving can be attracted from all areas. This requires the existence of atleast some financial institutions with connections with different regions of a country.

An investment activity is largely confined to a specified class of business which possesses the necessary technical expertise and market informations as well as the temperament to use it. On the contrary the activity of saving is largely diffused amongst innumerable surplus units which lack the skill, capacity and temperament to use their unspent current income for investment purposes and therefore, a transmission mechanism is inevitable to transmute surpluses from UUs to ITBs. The existence of financial markets can provide the transmission mechanism. The financial intermediaries not only promote SIP but they are also in a position to meet with geographical obstacles in the way of SIP through the wide network of financial institutions spread over the country. Due to economies of scale they are in a better position to achieve efficiency and economy in the whole process of transformation of saving into investment.
Intermediating techniques as discussed earlier in this chapter tend to raise the levels of saving and investment more efficiently by providing alternative investment opportunities and in turn they help to accelerate economic development. They transfer primary securities into indirect securities for the portfolios of UUs. They give lenders a wide variety of financial assets particularly suited to their needs. They enable spending units to escape the straight jacket of balanced budget.

Financial Superstructure.

All developed countries with mixed capitalist economies have well-developed financial superstructure, that is, well-developed financial institutions and markets with wide range of assets and liabilities. All less developed countries are characterized by varying degrees of less developed financial superstructure. Both in the past and in modern times, long run economic development of a country has either coincided with or followed the maturing of a financial superstructure. It is for this reasons that whenever the private financial superstructure is less developed and insufficient, government promotes the development of various kinds of financial institutions and markets through fiscal, monetary and legal measures. 19
In the absence of an adequate financial superstructure, a greater proportion of people's savings is in real and speculative assets relative to financial assets. But as the risk, liquidity and cost characteristics of the former are often favourable only to large savers, small savers generally resort to hoarding as a form of saving. They may hoard cash, commodities, land, precious metals and jewellery etc. When saving is hoarded in these forms, it does not contribute to real producers' capital formation. Even for large savers, the range of productive investment opportunities is limited by their individual access to markets and the indivisibilities of many productive investment. Thus, an inadequate or less developed financial superstructure can be associated with a greater proportion of savings invested in what may be referred to as socio-economically 'unproductive' assets relative to 'productive' ones.

The spending units can neither invest more than their saving because there would be no way, to finance excess expenditure. And no unit could invest less than its savings because there would be no financial assets other than money to put their savings in. They would be forced to balance their budgets with saving equal to investment. This stage of affairs, naturally would lead to a relatively low level of $1$ and hence it will retard the rate of economic growth of the country.
Moreover, in the absence of financial intermediaries, there would be inefficient allocation of resources and relatively inferior investment projects would be undertaken because efficient ordering of investment opportunities judged by their expected rate of return is not possible. The existence of financial intermediaries would permit some spending units with highly promising investment opportunities to undertake investment expenditures in excess of their saving and would allow others, who do not have such opportunities and entrepreneurial capabilities to save in excess of their real investment through the accumulation of financial assets. Financial intermediaries manufacture liquidity. They make money available to spenders by taking in return the securities that are long term and relatively illiquid. At the same time, they create and issue to savers claims i.e., secondary securities that are more marketable, less risky and more safe and of the short term maturities. Financial intermediaries, therefore, play a very important role in the SIP by raising the levels of saving and investment and allocating more efficiently the scarce saving among the most productive investment.

Financial Institutions in Underdeveloped Countries.

In underdeveloped countries savers typically prefer to accumulate tangible assets e.g., real estate inventories in place of domestic primary and secondary financial assets.
This reflects in part the traditional experience with inflation, expropriation, and default, and in part prejudice, uncertainty, and lack of information. But most importantly, it reflects primitive financial technology. Such wealth forms represent low priority investment for purposes of economic growth, yet investors in 'high priority' capital projects may be unable to issue primary debt to finance their deficits on terms acceptable to such savers.

The financial institutions in underdeveloped countries are faced with two problems:

1. In some countries, people are inherently attached to physical assets as the safest security.
2. In countries where industries are family-owned firms, new investors are not permitted to participate.

Under these circumstances, the financial institutions are to convince the depositors that in depositing their savings with the financial institutions, they can avail themselves of the services that those institutions are prepared to offer to them. Now to overcome these problems and to mobilize savings from scattered savers spread over the country and to channelize them to productive investment units in order to stimulate SIP and in turn promote economic development. The basic requirements is to erect a kind of financial superstructure in underdeveloped countries.
But the erection of the financial superstructure depends partly on the opportunity cost of setting up a particular financial institution: and partly on the benefits that would be derived from increasing saving and a better allocation of funds for investment.22

In a rudimentary stage of an economy self financing was the only method of financing. In developing economies, the importance of, and emphasis on self-financing is gradually declining. In all the sectors - namely, government, business and consumers - there is a tendency to rely less on self financing, and external financing has acquired relatively more importance during the process of economic growth.

Methods of External Finance:

Methods of external financing can be classified into two categories:

1) Direct finance,

2) Indirect finance.

In the direct financing method, deficit units issue debt instruments of their own (direct debt) and hold financial assets in the form of direct securities. When the capital formation takes place with the help of direct
finance debt tends to accumulate pari passu with wealth. In direct financing primary securities are the only securities that are transacted in the market but as the primary securities are more risky, less marketable and unsafe, ULS generally have less preference for them. Here lies the scope for financial intermediaries to intermediate because ULS are more inclined to put their surpluses in the hands of financial intermediaries and hold indirect securities in their portfolio. The primary securities issued by UBs are highly suitable for the specialised functions of the financial intermediaries. This is the case of indirect finance.

The emergence of financial intermediaries change the entire edifice of finance in the economy. With a rapid rate of growth in a developing economy the need for finance increases. Financial development is incomprehensible apart from its context to real developments. Markets for goods and markets for securities (including money) are simultaneously the media through which spending units seek optimal adjustment between income and spending, net worth and wealth. Excess demands for current output are of necessity excess suppliers of securities and the sectoral location of excess demands partly determines the types of primary securities that will be issued. The real world and the financial world are two sides of the same single world.
The development of financial institutions, therefore, is an important stage in the process of SI and economic development of underdeveloped countries.

In underdeveloped countries we notice an increasing importance of institutional investors in accumulating savings and allocating them to various investment uses. The extensive financing of large scale industries and the effective use of modern technology is not possible without simultaneous growth of financial institutions. Financial intermediaries are emerging in these areas successfully and savers have become aware of the benefits of diversification of investment, and assistance and guidance based on the specialized knowledge and experience that these intermediaries can provide. Promotional activities on the part of these institutions and increasing awareness of financial securities have helped a healthy growth of financial intermediaries. Changing atmosphere in underdeveloped countries, their emphasize on rapid industrialisation programmes and their plans to increase the national output at a faster rate have necessitated corresponding development in the financial structure of these countries.
Conclusions

The growth of financial assets is very vital for mobilization of savings. The financial intermediaries by offering a wide variety of financial assets suitable to the choice of savers help to raise the propensity to save. In a rudimentary type of economy there is dearth of suitable and attractive financial assets which may ultimately inhibit the mobilisation of savings.

Generally the surplus units are not the investing units and direct financing is not the efficient mechanism of transferring funds from surplus units to deficit units. The existence of financial intermediaries provides transformation mechanism through which the transaction of saving into investment becomes possible.

Financial intermediaries manufacture liquidity and therefore, they can play a vital role in the SIP and economic development. Thus, the financial intermediaries can do much in the efficient mobilization of saving and channeling it into the more productive investing units which may ultimately promote the growth process.
References


15. Ibid., p. 123.


