CHAPTER 1

INSTITUTIONAL FINANCING AND ECONOMIC DEVELOPMENT

1.1 INSTITUTIONS AND ECONOMIC 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 the already established ones.

The contribution of capital to economic progress embraces at least three distinct processes. First, a greater abundance of capital permits the introduction of more roundabout methods of production or to be more precise, a more roundabout pattern of consumption. This covers the freer use of capital instruments in the production of a given product. Secondly, the accumulation of capital is a normal feature of economic expansion — normally referred to as widening rather than deepening the structure of production. Thirdly, additional capital may be required to allow technical progress to take place. This may either result in the financing of the discovery of what was not known before or more commonly perhaps in the adaptation of present knowledge so as to allow of its commercial exploitation through some innovation in product, process or material. As

asserted by the writer, the direct as distinct from the indirect impact of technical change on capital requirements has been little studied as an empirical process.

Financial considerations have begun to dominate the field of production to such an extent that, no wonder we may say that industrial development is to a certain extent limited by the availability of finance. In a modern money using economy, finance may be defined as the provision of funds at the time it is wanted. As modern production is in anticipation of demand, the impact of the availability of capital to modern industry is of immense significance. As is observed by Prof. Gregory, "finance is one of the most potent and almost the least impeded of the agencies integrating the modern world into a single economic system".

Different institutions have differentially productive consequences. Growth promoting institutions without themselves adding resources to the economy may so restructure the environment in which factors of production meet, that the rate at which combinations occur is accelerated. Besides technological and investment surveys, as bases for programming technical assistance and capital projects, there is a need for

institutional surveys and institutional programming\textsuperscript{4} - the term institution referring to organisations and policies, both governmental and private. As regards cost benefit relationships in such an environment, "Institutional innovations which do not lower fixed costs may have a comparable effect on entrepreneurial calculations by making such costs easier to bear. Thus establishment of a publicly supported market for equity capital may enable an entrepreneur to share fixed assets by sharing ownership." The example of the stock market set up by the Government of Indonesia at Djakarta may be cited as an instance. Also, credit institutions may facilitate the bearing of fixed costs by altering the share of initial investment requirements which can be met from the entrepreneur's future income rather than his current resources. "Generally in under-developed countries few institutions perform the normal function of extending long term credit. Those which appear to do so often impose prohibitive collateral requirements and interest charges which in practice sharply restrict the access of entrepreneurs to loan funds. Under such circumstances, the alternative credit facilities and policies may be a pressing though not readily apparent requirement for accelerated growth\textsuperscript{5}.

By their effects on the structure of rewards in a society, institutions may differentiate between those responsible for adopting and financing innovations and those benefitting


\textsuperscript{5} Ibid. pp. 352-353.
therefrom. Under such circumstances a marked inertia to the adoption of improved methods will tend to persist despite growth promoting motivational and perceptual patterns.

In a developing country, institutional arrangements for the mobilisation and channelling of financial resources must be continuously expanded and adapted to the growing and varied needs of the economy. It is not merely a question of the quantum of the financial flow in the aggregate, but also a matter of the sectoral flow. The different sectors have their own special features and problems. This does not mean that this is a problem faced by the developing countries only. Even in developed economies, the need for establishing special financial institutions is being increasingly felt, though perhaps the quantum of assistance channelled through them is small in relation to what is provided by the ordinary capital market mechanism. Perhaps in developing economies the need for such institutions is much greater and in this matter, a great deal of initiative and assistance is called for by the Government and its agencies.

"Fundamentally, the capital market is not different from any other market. The market mechanism is essentially called for, because of the fact that we have an exchange economy with specialisation of functions. In the present day world, to a not inconsiderable extent the people

who initiate investment activity do not have funds for the purpose, while there are also people who save but who have no desire to utilise their savings directly for investment activity in the sense of establishing a factory or any other business enterprise?.

1.2 **Finance for Industry**

   Industry in general requires two kinds of finance:
   
a) Fixed or Block Capital, and
   
b) Floating or Circulating Capital.

Fixed capital is required for the acquisition of fixed assets and floating capital to meet the day to day requirements of the industry. This leads us on to a proper definition of fixed assets and circulating assets. According to Prof. Paish, "we shall not go far wrong if we define circulating assets as those which turn over frequently and are valued with reference to the quantity in stock and fixed assets, as those which turn over slowly and are valued with reference not only to their number and cost, but also to the number of years of useful life which remain to them". In keeping with such a definition, installation of buildings, plant, machinery etc. may be deemed as fixed assets and the capital acquired in this context as block capital which will be spread out over a number of years. On the other hand capital acquired to satiate current needs like


paying wages to labour and other daily needs come under the
caption of floating or circulating capital. The major line of
demarcation between the two is that, while extreme fluidity
characterises the latter, block capital becomes crystallised.
The exact nature and proportion of these two kinds of capital
will have to be determined by the industry concerned. It will
beclear therefore that the amount of working capital required
will vary enormously between different products, corresponding
to variations in the length of process— from next to nothing
in the case of personal services upto the equivalent of a year's
outptor more in certain other cases. However, it is necessary
to point out that business ability always stands in need of
adequate and flexible supply of industrial finance.

As the German writer Von Beckerath observes, "It is
essential for modern enterprises not only to make profits, but
if possible greater profits than their competitors, as finan-
cial success is their only guaranty of existence". We may
mention here that there are four different ways of provision
of new capital. Firstly, a certain proportion of the profits
of the firm may be appropriated before declaring dividends and
this may be utilised towards this end. This type of financing,
known as self financing has got its own features. Hence, the
original stockholders have the privilege of participating in
the new issue market, retaining their proportionate share of

ownership. Also, the consideration of safety is properly looked after. But such financing prevents proper distribution of newly accumulated or other unoccupied capital over the various branches of production. Again, only established concerns of great reputation can resort to this method. "Though self finance has been the most important source of funds for investment, the private business sector in many western European countries relies heavily on non marketable forms of credit granted by banks and non bank financial institutions, both public and private to finance investment in general. The relatively small importance of the new issues market is partly a reflection of the inadequacy of those markets, but also partly a consequence of the close direct links between financial institutions and industry in many European countries". A similar view has been expressed earlier by other writers also. "Self finance continues to be important in the most sophisticated economic system, say in the form of investment out of retained corporate earnings. But over the very long term, the trend has been away from self finance. Government, business and consumers alike have come to lean more heavily on external finance". Secondly, yet another method of raising new capital is by means of issue of fresh stock. There are three methods;


(a) Resorting to the sale of stock, reserved in the treasury,

(b) Sale of stock may also take the form of assessment upon partly paid stock, or

(c) Lastly, by the issue of new fully paid stock - often this method is resorted to.

Thirdly the provision of new capital may be made possible also by borrowing money either on short term obligations from banks or by selling mortgage bonds to the investor. Two kinds of certificates of indebtedness are issued -

a) floating debts, notes sold on short term obligations and

b) funded debt, sale of mortgage notes as a lien upon specified portions of property, payable after some years.

Such long term bonds may further be divided into,

a) debentures, usually bonds without special security and

b) bonds with special securities like mortgage bonds, collateral trust bonds etc.

The capital needs vary depending upon the nature of the industry. As between industries, the capital requirements in relation to the output are not identical. They vary even from unit to unit within an industry. Presentation of investment opportunities\(^1\) forms a 'sine qua non' condition of ordered

\(^1\) The functions of the promoter may be divided into three different stages - discovery, assembling and financing the business proposition. (E.S. Meade: Corporation Finance).
industrial progress and in this context the promoter and his functions acquire great importance. This leads us on to the concept of risk bearing. Risk bearing, as the very term implies may bring in either an amount of gain or loss and this depends on three forces:

a) The rate of social change,
b) The degree of imperfection of knowledge and
c) The immobility of invested resources -

as Prof. Lavington\(^\text{13}\) groups the first two factors may be brought under the caption of risk arising from imperfect knowledge. Risks in general may be broadly categorised into physical risks, technical risks and economic risks. Physical risks are risks which may destroy some physical good created by the work financed like dangers from fire, flood, storm etc. The term technical risks denotes lack of skill of the producer. But of all these, economic risks are the greatest and always the least calculable of all. Economic risks may be divided into

a) risk due to shortage of capital, and

b) risk arising from a fall in the demand for the product.

The first kind of risk is greater under a controlled economy than under a market economy; for such a system points to the fact that once an item cannot be obtained at the price officially fixed, it cannot be obtained at all, even at a higher price. The second kind of risk arises due to various causes. It may be due to the trade cycle, or to a miscalculation of consumer's tastes or shortage of the complementary good in the case of a joint product etc.

\(^{13}\) F. Lavington: "The English Capital Market".
1.3 INSTITUTIONAL FINANCING: A UNIVERSAL TENDENCY

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 characteristic developing economies, the prospects for the rapid development of a 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 industrialisation process, virtually all countries of the world, developed and under-developed have established special institutions to mobilize their resources of capital and channel them into the productive economy. In the past twenty-five 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' or 'development finance companies'. "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."\(^{14}\) Such specialised 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. These institutions assume the shape of either,

a) Finance Corporations or

b) Development Corporations.

A development bank is a synonymous usage for a finance corporation. It is an institution primarily engaged in the provision of loan finance to a particular category of business units by guaranteeing or granting long term loans. A development corporation on the other hand, is an institution "which takes the initiative in the creation, direction or operation of individual enterprises. It characteristically supplies part or all of the equity capital required for such enterprises rather than loan funds and frequently assumes responsibility for management and control."\(^{15}\).


The need for such specialised institutions was not felt in England till the appointment of the Macmillan Committee. In June 1934 was set up the Charterhouse Industrial Development Company by the Charterhouse Investment Trust in combination with the Presidential Assurance Company and two of the 'Big Five' - the Lloyds Bank and the Midland Bank - with a capital of £2,000,000. In 1945 was set up two new corporations, the Industrial and Commercial Finance Corporation (ICFC) and the Finance Corporation for Industry (FCI). Mention may be made here also of the Commonwealth and the Colonial Development Corporation providing finance to projects in colonial territories to supplement the work done by private enterprise.

In Germany the only private institution specialising in long term loans to industry is the Industriekredit Bank A.G. in Dusseldorf (1949) often referred to as the IKB. Among public institutions the Kreditanstalt Fuer Wiederaufbau (KFW) established at Frankfort in 1949 stand in the foremost. The main purpose is to provide medium and long term loans for the German reconstruction. In France, attempts made by companies did not meet with much success. But the rediscounting mechanism afforded by the Central Bank has found much favour with industrialists. The Caisse des Depots et Consignations (C.D.C.) by discounting the bank's bills arising out of advances to industry makes available a large amount of medium term credit. Special requirements of small and medium sized firms are taken care of by another special institution. ('Caisse Centrale').
In Italy there are three principal private institutions providing long term finance viz. 

a) Mediobanca (Banca di Credito Finanziario),
b) Ente Finanziamenti Italiani (E.F.I.), and 
c) Centro Banca (Banca Centrale di Credito Mobiliare).

There are also some public institutions. After the Bank reform of 1934 in Belgium, two private finance companies have come to prominence - Societe Generale de Belgique and Brufina. This apart, there are numerous semi public institutions owing their great expansion to the last decade or so. A different situation prevails in Austria where no public institution lends to industry, apart from the three biggest banks, since nationalised. The existing commercial banks themselves supply considerable amount of finance to public authorities. Government finance is made available to industry through the channel of two special funds. Long term needs of small and medium sized firms is looked after by the A.B. Industriekredit formed in 1934 on the Government's own initiative. There is no special private agency or institution existing in Greece. The existing Organisation for Financing Economic Development supplies long term industrial finance, this institution having been started under an agreement between the Greek Government and the U.S. Mission to Greece, ratified by law in 1954. Similar institutions have also come to stay in the U.S.A. The Reconstruction Finance Corporation was created in 1932 to provide emergency financing facilities for financial institutions to aid in financing agriculture, commerce etc. Help is extended to small
industries through various Development credit corporations which are in vogue in most of the Eastern States. Canada came forward with the Industrial Development Bank in 1944 for supplementing the operations of existing institutions in providing intermediate and long term credits for small business units. This is a fully owned subsidiary of the Bank of Canada. Such a tendency may be found in the Latin American countries also like Chile, Argentina, Brazil etc.

Some general features seem to underlie the formation of such institutions. It may be noted that these institutions have been established to fill the gap in the machinery for financing industrial development. Most of these institutions seem to have been organised on an autonomous basis and they perform a variety of functions like promotion, underwriting, mortgage lending, subscribing to debentures, equity capital etc. India is no exception to this and the aftermath of partition has witnessed the emergence of an array of financial corporations. The principal finance corporations at present existing are:

(a) The Industrial Finance Corporation of India,
(b) The State Financial Corporations,
(c) The National Industrial Development Corporation,
(d) The Industrial Credit and Investment Corporation of India,
(e) The Unit Trust of India, and
(f) The Industrial Development Bank of India.
1.4 **FINANCIAL INTERMEDIARIES IN THE MODERN ECONOMY:**

Financial intermediaries 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 investments. "Self financing was the only method of financing in a rudimentary stage of an economy. 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." External financing involves two methods - direct finance and indirect finance. Direct finance involves borrowing from surplus spending units by deficit spending units. Deficit spending units issue debt of their own (direct debt) and hold financial assets in the form of direct securities. In this manner, economic development takes place in the private sector where expenditures are financed to a great extent by external means. In direct financing, primary securities are the only securities that are transacted in the market. Financial intermediaries may be classified as primary and secondary ones. Primary financial intermediaries are those which draw their funds directly from households, business enterprises or Government and make them available in turn to the same groups.

Commercial banks and life insurance companies are examples for

such a type. On the contrary, secondary financial intermediaries depend for most of their funds on primary financial intermediaries or use their own funds to acquire the securities of primary financial intermediaries. The specialised financial institutions listed in the earlier section come under this category. It may be of interest to note here that the distinctions between the banks and non-bank financial intermediaries are gradually disappearing. This is noticeable both in the U.S.A. and U.K. A satisfactory classification of financial intermediaries will vary from country to country and will change from time to time. Prof. R.W. Goldsmith in his book\(^{17}\) groups them under five different heads.

(a) The banking system,
(b) Other depository organisations,
(c) Insurance companies etc.,
(d) Other financial intermediaries and
(e) Personal trust departments\(^{18}\).

According to Prof. Goldsmith, financial intermediaries include most of the units falling within the classification of financial enterprises, but are not identical with them. Financial

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17. R.W. Goldsmith: "Financial Intermediaries in the American Economy since 1900" (National Bureau of Economic Research, Princeton University Press, Princeton) p. 32 (1956). (Such a classification, as remarked by the author, is mainly applicable to the U.S.A.).

18. Group (a) consists of the Federal Reserve System, Commercial banks, Savings banks and the postal savings system; Group (b) consists of savings and loan associations and credit unions; Group (c) comprises of private
intermediaries are taken to include all financial enterprises with the exception of two types,

(1) Units whose assets consist predominantly of the securities of, or of claims against wholly owned or majority owned subsidiaries, and affiliates and

(2) Units owned by one or a small group of individuals, or by corporations or non-profit organisations, if they make no substantial use of outside funds.

The main function of the financial intermediaries to purchase primary securities from ultimate borrowers and issue indirect securities to ultimate lenders. 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. Particularly in under-developed countries, where savings are institution elastic, they respond readily to the stimulus of new saving facilities provided by the financial intermediaries. This is bound to affect the total volume of savings as well as its direction.

The growth of the non-bank financial intermediaries relative to the commercial banks increases the potential ability

...
of the financial system to expand credit. "In fact, the growth of the assets of the non bank financial intermediaries progressively provides close substitutes for money and represents in part, a desire of the community to hold more of its savings in the form of financial claims and this tendency becomes more and more prominent as the community's stock of wealth reaches higher and higher levels".19.