CHAPTER VI

SUMMARY AND CONCLUDING OBSERVATIONS

"Thus the theoretical model and empirical results under discussion do not, unfortunately, lead to any simple resolution of the main disputed points in macroeconomics. As has been shown a passive monetary authority would create behaviour in the money supply that would make money seem exogenous and make it appear to explain prices and real activity. But the same result would emerge if money stock did in fact explain real activity and the monetary authority moved it around erratically.


Introduction

This thesis has focussed its attention on several aspects of the linkages between financial sector indicators and real sector. The role of finance in determining real sector activities was recognised quite early during the post World War II period. The interest in the financial aspects of economic growth stems from three major strands of literature. The first one relates to financial intermediation, which can be traced to Goldsmith (1969) and Gurley and Shaw (1955, 1957, and 1960). The second relates to financial repression and liberalisation (McKinnon and Shaw, 1973). Third relates to endogenous growth literature [Greenwood and Jovanovic (1990), Romer (1990), Bencivenga and Smith (1991), Roubini and Sala-i-Martin (1992)]. There are other dimensions as well such as, innovations, deregulation, diversification, reforms and policy [Tobin and Brainard, (1963), Spellman (1976), Mathieson (1979), Fama (1980), Homgren (1985), Gelb (1989)].

Chapter I briefly narrates the importance of the financial aspect of development and brings in the crucial role of the financial system in India. It also
brings out the gaps in the theoretical and empirical literature and discusses the limitations of the study. Keeping in view the limitations and gaps in the extant literature, the objective of the present study was to review all aspects of financial development in India from 1950 to 1997 and to review and make a comparative analysis of performance of various groups of financial intermediaries in India. The aim was to present an analytic study of the changing role of financial institutions in a developing country in the process of planned economic development and identify the determinants of indicators of linkages between financial development and economic growth. Lastly, it also examines the causal linkages between financial sector indicators and real sector. In India, Investment as a financial asset is the driving force behind financial development. In the context of deregulation, liberalisation and financial reforms, private investment has become a crucial component of financial development. With monetary policy aiming to ease liquidity conditions through a reduction in the statutory reserve requirements, more funds are now available to the private sector. In this context, the aim is to examine the crowding in effect of public investment on private investment, and to suggest policy implications and future research agenda.

Chapter II presents in detail the developments in the theoretical and empirical research and brings out the issues. Many developments in theoretical literature in the recent years on endogenous growth have given a new focus on relationship between financial development and economic growth. It recognised the crucial
importance of determinants of long-run economic growth relative to business cycles or counter cyclical effects of monetary and fiscal policies.

Empirically, the question of causality remains unresolved. In reality, financial and real sector interacts during each stage of development and hence there is no one-way relationship between the two. There has been a wide range of empirical research cross-country or country-specific studies, oriented towards developed or developing countries, employing different models, a variety of variables and a wide range of econometric techniques. However, their results are variegated and contrast.

In the above background, certain gaps in the extant literature have been identified as follows: firstly, there are strong and divergent views both on the theoretical as well as empirical front. More specifically, there is a growing debate on the causal linkage between financial development and economic growth. It is still a matter of doubt whether financial development leads or lags real sector or is a 'demand-following' or 'supply-leading' phenomena or whether the causation runs both ways and significant or whether the interest rates or savings rate or investment provides the transmission channel; whether financial deregulation, liberalisation, innovation, diversification and reforms is an unequivocal policy panacea. Secondly, the conclusions are divergent both in the cross-country and country-specific studies. As the growth paths are not similar over the long run, earlier models cannot be easily adopted in developing countries. Thirdly, there are methodological
differences that necessitate careful interpretation of the empirical results. Fourthly, it is necessary to consider various dimensions in the present study in respect of new determinants, variables, structural disturbances over the long periods that are absent in the earlier studies. As the financial development varies at different points in the growth path, a systematic testing on a country-specific basis over sufficiently long periods of time through the use of latest advanced techniques has become a necessary exercise in itself.

In the Chapter III, the financial system of India is reviewed in terms of evolution and history of the financial system in India, role of financial system in economic development; economic contributions of the financial system, structure of the financial system including on types of financial institutions, instruments and markets, indicators of financial development and lastly discusses the financial sector reforms. The Indian financial system has made rapid strides in facilitating intermediation, innovation of new instruments and institutions. It has played a key role in integrating various financial markets in the country particularly since the era of planning for economic growth. During the last four to five decades, the number of financial intermediaries has grown and there variety of new instruments to cater to the varied interests of the investing community.

The characteristics of the financial sector have undergone a sea change. As compared to the earlier decades, the number of institutions has more than doubled and diversified into non-traditional activities. The financial widening and deepening
achieved in the last five decades are indicated by a few ratios. The trends in these ratios are indicative of the rapid growth of the financial structure, increasing institutionalisation of savings and increasing division of savings-investment functions of various economic sectors. The Indian Financial System has made rapid strides in facilitating intermediation, innovation of new instruments and institutions. It has played a key role in integrating various financial markets in the country particularly since the era of planning for economic growth. During the last four decades, there are a variety of new instruments to cater to the varied interests of the investing community. A number of the specialized financial institutions have emerged which have broadened and deepened the financial system as a whole.

Technological developments which were minimal or non-existing prior to mid-eighties became advanced in the later period. With the help of technology, screen-based trading have been introduced in the debt and capital market. Delivery versus payment system have been introduced to synchronise cash payments with securities transactions. Auction system in the Government securities market have been introduced. With the rapid development in technology, electronic bidding will become common in future.

Lastly, the financial sector reforms have been an ongoing one and introduced in stages to suit the macroeconomic conditions and plan objectives. In the first stage, several measure relating to the money market were introduced since the mid-eighties based on the recommendations of the Committee to review the Monetary
System (or the Chakravarty Committee, 1985) and the Working Group on Money Market (or Vaghul Committee, 1987). In the second stage, reform measures were introduced based on the recommendations of the Committee on the Financial System (or the Narasimham Committee, 1991) which were related to deregulation of interest rates so as to reflect emerging market conditions. In the third stage, the focus was on banking sector reforms (Narasimham committee II). The financial markets are getting more and more integrated particularly since the 'nineties. More freedom was given to open branches and also the emergence of new private sector banks. Emphasis was placed on transparency, adherence to accounting norms and to other prudential norms.

One of the major objectives of financial reforms in India has been to integrate financial markets so as to transmit monetary policy actions through the financial system. This can be through the changes in the rates of return on the financial assets with the institutions facilitating movement of funds. The commercial banks are an important segment of the financial system. A need has arisen to facilitate market-determined credit allocations, which is possible if other markets develop.

Chapter IV concentrates on the operations of the financial intermediaries in India in terms of trends in growth and their asset profiles, sources and uses of funds, income and expenditure analysis. The financial system in India is endowed with a vast network of financial institutions and instruments. The trends in growth of assets of all financial institutions coincides with the fact that during the period I,
foundations were laid with the establishment of new institutions, such as Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, Life Insurance Corporation, Industrial Development Bank of India, Unit Trust of India. While these institutions along with the banking institutions grew in the period II, in the last period, further growth and qualitative changes were brought in through liberalisation, diversification and reforms measures were undertaken in the context of foreign exchange crisis, accumulation of large non performing assets by banks and it was during this period structural adjustment programme was initiated. It was also observed that a similar pattern of growth prevailed for the banks and the non-banks (which includes financial institutions, non-banking financial and investment companies and mutual fund institutions). The overall growth rate for non-banks and banks were higher than that of all financial institutions; although non-banks grew at a faster rate than banks in all the periods under reference except during the period 1970-86. This reflects the spectacular growth in the banking system since their nationalisation.

An analysis of the data shows that although India is endowed with a variety of financial institutions, each having a different purpose, these became operational at different points of time thereby changing the financial structure. Secondly, the growth of different financial intermediaries have been uneven. Given the same financial environment, the different types of institution have performed differently. An exercise was also done to study the factors affecting investments and credit of various institutions. The results showed that several factors had a positive as well
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as negative and significant influence on credit and investments of various institutions. The policy variables such as Cash Reserve Ratio and Statutory Lending Ratio had significant impact on the banking institutions. Interest rate variables also influenced other institutions as well. These were as per theoretical expectations. The structural breaks on account of financial liberalisation, deregulation and reforms were evident during the three periods.

It also showed that a comparative analysis of different types of financial institutions would provide rich insights into their workings and problems. In the light of this experience, setting up of newer institutions in future would go a long way in helping these segments of society with better financial infrastructure that would enhance growth.

Chapter V attempted to empirically analyse the linkages between financial sector indicators and real sector indicators in India. The financial development in India has taken place rapidly. The financial system is endowed with a vast network of institutions which is in line with its planned objectives. Following a mixed economy pattern, there are institutions in the public and the private sectors. India from the beginning of its first five-year plans has been following a multi agency system to foster economic growth. The financial development in India has taken place rapidly. It is of interest to note that the process of fiscal consolidation which was an integral part of financial sector reforms began in 1991-92, reduced the dependence of the Government sector for funds from the banking sector and in particular from the Reserve Bank. Further, the policy of credit restraint squeezed the borrowings of the
non-departmental commercial undertakings from the commercial banks. The non-banking financial intermediaries substituted the banking sector to meet the gap in resources. With the rapid growth of the mutual funds institutions and term lending institutions for modernisation and rehabilitation enabled these institutions to enhance their shares.

Investment is one of key linkages through which macroeconomic policies influence the real sector. The nature of the linkage varies as between countries, the theories of investment differ in terms of the channel of influence. Besides, two opposite views have emerged. One school advocates that public investment 'crowds out' private investment in the growth process when the former utilizes the scarce resources which normally is available for the use of the private sector. This takes place when the public investment results in the production of marketable goods, which competes with those produced in the private sector. Alternatively, if public investment were financed through taxation, inflation or debt, it would reduce the resources available to the private investments and hence reduce private sector investments. The second school argues that the 'crowding in' occurs when public investment takes place in the form of infrastructure or public goods, it would play a complimentary role to private investments. The 'crowding in' effect is brought about by raising capital productivity, which in turn, pushes up the demand for inputs and other services. All these eventually increase the demand for output produced in the private sector and hence there is an increase in private sector investments.
After identifying the two opposing views on public and private investments, the relevance of this in the Indian context was examined. For the purpose of analysis, multiple cointegration technique of Johansen-Juselius was adopted. The results showed that public investment crowds in private investment in India.

The key macroeconomic link between real and financial sector comes through the saving-investment behaviour, which sets the pace of activity in the economy. In terms of economic growth, trends in investment are important as it not only adds to capital stock, but also helps to determine the supply potential of the economy over the long period of time. Investment as a component of financial asset is a driving force for financial development in India. In the present context of liberalisation and diversification, financial sector reforms and globalisation, investment has become a key variable. While part of the saving is in physical assets, a large part of it is in the form of financial savings that gets determined through the process of financial intermediation. The financial intermediaries play an important role in collecting and analyzing information so as to channel investible funds to investment activities yielding highest returns. It is in this context that the private saving and investment behaviour is of a critical importance. In developed countries, it is often considered that if public sector accounts are balanced then the private sector saving behaviour should be entirely left as a private agent's decision with no necessity of any government intervention. Nevertheless, what influences private investment is a matter of economic interest as it has a pronounced influence on overall macroeconomy. This influence is all the more important in case of
developing economies. It is in this context that we worry about private investment behaviour in India. Study of the long-run linkages of private investment has been important, particularly so after the liberalization and reforms. The Government has consciously taken a decision to borrow at market related rates and to reduce its fiscal deficit of the central government. Thus, it also, in turn impacts Government expenditure, particularly the capital expenditure. Reserve Bank too has been emphasising on the importance of reducing Government borrowings in its Annual Reports.

Investment plays a crucial role not only in financial development but also in the economic growth process. In general, financial intermediation facilitated this process of efficient pooling of surpluses of the savers and channeling them as investments to sectors having financial deficits. The quality of investment is important in setting the rate of growth. It depends on many factors, of which efficiency of investment is the most prominent one. As the investment kitty comprises public and private investments with the former showing a declining trend due to several factors such as awareness to place a limit on government borrowing, the Government's decision to restrict the Gross Fiscal Deficit (GFD), the changing perception in the operations of the government undertakings etc., besides, with monetary policy aiming to ease the liquidity conditions through a reduction in the statutory reserve requirements, more funds are now available to the private sector. This, therefore supports the 'crowding in' theory.
There is a large role for government intervention which can take many forms. Policy makers can coordinate private sector production and investment decisions through interventions in credit allocation, taxation and industrial policies and regulations.

Policy Implications

The main policy implications arising from present study are:

First, financial development is a precondition for economic growth. The transmission channel between real and financial sector comes through the saving-investment behaviour. With the rate of savings reaching its peak level, in India, there is a large investment potential, which is yet to be tapped. In terms of economic growth, trends in investment are more important as it not only adds to capital stock, but also helps to determine the supply potential of the economy over the long period of time. Investment as a component of financial asset is a driving force for financial development in India. In the present context of liberalisation and diversification, financial sector reforms and globalisation, investment has become a key variable. The financial intermediaries play an important role in collecting and analyzing information so as to channel investible funds to investment activities yielding highest returns. It is in this context that the private saving and investment behaviour is of a critical importance. Study of the long-run linkages of private investment has been important, particularly so after the liberalization and reforms. The Government has consciously taken a decision to borrow at market related rates and to reduce its fiscal deficit of the central government. In this context, increasing the private
investments becomes important. In the context of placing a statutory limit on Government borrowings, the Government can increase its expenditure on those areas, such as infrastructure, which would provide a positive stimulus to the private investments and thereby enhance economic growth. In view of the changing perceptions on the public sector undertakings, there is more room for privatisation.

Second, in order to see that such investments are efficient, financial sector reforms should be an integral part of economic reforms and plan policy objectives. While the reforms should be ongoing and properly sequenced, the policy formulations should be implemented on time.

Third, in the context of financial liberalisation for enhancing growth, the present level of Government intervention in the interest rate mechanism is necessary in the light of the experience of the East Asian crisis.

Lastly, the regulatory framework needs to be strengthened by repealing the out-dated and irrelevant regulations. Besides, new ones need to be introduced according to the new financial environment where technological upgradation is an integral part, so as to eliminate frauds and malpractices.

Future Research Agenda

The major area of future research emerging out of the study are:

(1) Future research could concentrate on country specific studies using the latest econometric techniques as data for a large time period is available.
(2) Secondly, quarterly or monthly data series can be constructed and analysed, which will show a better picture on the volatility in the financial system instead of annual data.

(3) Thirdly, in a multi agency framework, studying the inter institutional linkages with empirical tools would provide another promising area of research. Future research could concentrate on constructing a national balance sheet on a consolidated basis, which is transparent.

(4) Another interesting area is the valuation of assets.

(5) Future research can identify what are the factors that influence the indicators of financial development, such as financial intermediation ratio, finance ratio, intermediation ratio, and the new issue ratio.

(6) For a developing country like India, developing a financial index will be an useful exercise by itself. A study of the regulatory framework for strengthening the financial system has become very essential particularly in the context of technological advancements.

(7) Lastly, an analysis of the impact of financial innovation, technology and reforms is another area for future research.