CHAPTER 6

SUMMARY AND CONCLUSIONS

We have attempted in the preceding chapters to analyze theoretically and empirically different aspects and dimensions of the role of money and finance in the process of Economic development with specific reference to the Indian Monetary and financial system.

We began by stating that a sound and efficient financial system can contribute to economic growth and development in a number of ways :

1. By providing a spectrum of financial assets to meet diverse preferences of households and thus enabling them to choose their asset portfolios to achieve a preferred mix of return, liquidity & Risk.
2. By pooling a large number of independent default risks and there by reducing the risk per unit of money deployed.
3. By raising productivity of capital through efficient allocation.

We have been persistently emphasizing throughout, the fact that the role of money and finance in the process of development of an economy like India has been understated; that the scope of monetary policy does not end just at a more exercise in short-run stabilization policy; that there is no doubt that a wisely formulated monetary and financial policy can remove a great many of the impediments that have been the major bottlenecks in the growth process; and that a long-run policy regarding the supply of monetary and non-monetary financial assets, has the potential of becoming a powerful lever to influence the rate and pattern of economic growth; the evidence, furnished in the study though not conclusive, is highly suggestive; it suggests that there is a high likelihood of a strong and positive relationship between the growth, widening and deepening of financial structure and real promoting growth forces.

From our analysis of flow of funds data and indicators of financial development (ratios of FIR, NIR, IR, FR), it was shown that during the study period, growth of financial transactions has been much faster than growth of economic activity and the real infrastructure development. Degree of institutionalization has increased considerably and the role of indirect

finance has been quite prominent; however in the more recent time period, it has shown stability and has even declined indicating some sort of process of financial disintermediation of all indicators, it is the finance ratio which has remained statistically significant in all periods (1950-51 to 1991-92, 1950-51 to 1970-71 & 1971-72 to 1991-93) explaining the changes in household savings over the sample period however, other ratios have been found to be statistically significant in explaining household savings except in the more recent period. The household savings had continued to contribute 70 to 75 per cent of total savings and within household savings proportion of financial assets has increased along with a decline in physical assets.

The saving investment gap of government sector has been continuously increasing; This gap has been financed largely by household, Banking system & to some extent OFI; compulsory savings statutory liquidity ratios and assets entailing fiscal concession have been the major instruments through which Govt. managed credit directed credit programmes have been major factor responsible for preempted credit and which has been criticized by the Narasimham committee. The private corporate sector has been mobilizing funds from HHs, Banks and OFI; here, mutual funds have played a major role in the more recent period. These public sector financial institutions undertaking term lending and investment activity have acquired an important position in the financial system. The financial assets of these institutions in the early 90's have stood at more than Rs. 900 billion as compared with an asset position of commercial and cooperative banks of around Rs. 1850 billion.

The real deposit rates have been found to be statistically insignificant in affecting savings; Although savings in a particular form are responsive to yield relative to other assets, aggregate savings out of a given level of income are not interest sensitive; however there is a need to see that the interest rate structure of organized financial system is in reasonable correspondence with market perceptions; it rates become negative, funds tend to more from the organized to the unorganized sector leading to loss of control over credit allocation of funds.

The evidence furnished in this study does not support financial repressionist hypothesis; The real deposit rate has not been only found to be statistically insignificant in affecting household savings investment and economic growth but also it has a wrong

(negative) sign. It points to the fact that financial liberalization, in the form of higher real interest rates, for stimulating real private investment may not work in the desired direction.

The saving rate is reported to be influenced statistically significantly (at 5% level) and negatively by the ratio of the total stock of tangible and financial assets to GDP and positively by ratios of total issues to GDP. Given this saving behaviour continuous expansion in financial activity and continuous financial innovational activity will be needed to counter the tendency to aim for a given wealth income ratio or of the negative effect of a given consumption wealth relationship on the saving rate; Also, a faster growth of GDP as compared with that of total assets to wealth, would be necessary in order to raise saving rate.

The capital deepening has a strong positive influence on the incremental productivity of capital; The financial deepening contrary to a priori expectations has negative influence on incremental productivity of capital; it may be rationalized by the fact that financial development in India as largely been used as means of diversion of financial resources through SLR and earmarking of flow of credit to the priority sectors, to sectors which had low incremental output capital ratios.

We have observed in the earlier chapters that money deepening has to precede the deepening of non-monetary financial assets because the latter has no meaning without the former. Money deepening involves increasing accumulation and use of real balances by the public which on the one hand increase the efficiency in clearing the "payments matrix" of the society and on the other make real resources available to the monetary system for lending to the investors.

The policies for money deepening will have to stimulate demand for real balances. There are no easy ways to do this because whereas the supply of nominal money is completely in the hands of the government and the monetary authority, the stock of real balances in society is entirely under the control of the public which can and almost invariably does reject an "unwanted" issue of nominal money by pushing up the price level. The public's desire to hold real balances is very sensitive to factors, like income, deposit rates, expected changes in deposit rates, realized and expected rates of inflation and their variability and the changes in the opportunity costs of holding money reflected by the rate of return on investments in physical assets, equity, kerb markets, and other investment outlets. However, at a point the deposits rate and the anticipated rate of inflation and its variability mainly determine changes in the public's

desired holdings of real balances. The real deposit rate is the most important and potent instrument to stimulate demand for real balances and it can be manipulated by regulating nominal deposit rates and the realized and expected rates of inflation.

An inflationary atmosphere created by excessive dose of nominal money stock induces the public to form positive expectations of future price level. A high expected rate of inflation reinforces the inflationary processes. The NNP at current prices in this situation grows at a rate even faster than the growth in nominal money stock and the M/Y ratio decreases. A reduction in the M/Y ratio is an indicator of the public's rejection of an unwanted issue of nominal money stock. Brazil and Argentina are examples where the public rejected excessive nominal money stock by pushing up the price level and so the M/Y ratio persistently declined.

India represents a case where inflation has not really done much damage but on the other hand money deepening is almost absent in initial years. Low deposit rates and positive and highly variable inflation rates are mainly responsible for this. Our model in Chapter 5 brings out clearly that demand for real balances is negatively and substantially influenced by the market rate of interest - the opportunity cost of holding money. The rate of interest paid on currency and demand deposits is zero so that the rate of return on other forms of financial assets or physical assets is the opportunity cost of holding savings in currency and demand deposits. The same for time and savings deposits is approximated by the market rate of interest not of deposit rates paid on time and saving deposits. Higher deposit rates will thus reduce the opportunity cost of holding savings in monetary assets as compared to physical assets and so demand for monetary assets in real terms will increase.

In India monetary authorities have generally tended to keep interest rates in the market for loans at low levels to boost investments. In the process, a continuous disequilibrium is maintained in the market for capital with an ever increasing demand for band funds which have to be rationed on priorities offered by the government to the "key" sectors. This policy is rationalized some times by the belief that the rate of return on investment is low in developing countries because of insufficient demand, lack of infrastructure, etc. There is enough evidence to suggest that this belief is not correct.

Low nominal rates of interest obstruct the functioning of the monetary system as a market clearing mechanism in the market for money and of the overall financial system in the market for capital. In countries, like India, savings are scarce and the price of savings should

adequately reflect their scarcity. Low nominal loan rates permit the investors to use savings indiscriminately without regarding their opportunity costs and in general lead to their wasteful utilization. They make labour expensive relative to capital and so encourage the use of highly capital-intensive techniques of production. The artificial cheapness of capital and the resultant waste in its use is also reflected in the construction of oversized plants by entrepreneurs which is one of the major causes of underutilization of industrial capacity.

Thus there is a strong case for the rationalization of the structure of interest rates to encourage monetary and financial deepening and to allow the monetary system to perform effectively as a market clearing mechanism for money and capital. Rationing of credit is expensive administratively and inefficient economically. There may be a case for preventing the flow of credit to some sectors like those producing luxury items. But using loan rates to clear the market for capital and using selective credit controls to regulate credit flow to industries low on priorities will make the distribution of savings efficient and prevent an indiscriminate use of this scarce resource.

When prevailing loan rates reflect the scarcity value of capital in an economy, like India, and give appropriate signals on the relative endowment position for labour and capital, labour-intensive techniques of production will be encouraged and this will have a favourable effect on employment.

Low loan rates also make it profitable for investors to construct oversized plants to make quick profits for temporary phases of high demand and boom. One of the major factors responsible for underutilization of industrial capacity in India is the installation of huge capacities in the beginning. If the price of long-term capital can reflect its opportunity costs, this process of trial and error in the choice of the plant size will become more expensive and the wasteful use of capital can be prevented.

Again, loan rates that reflect the scarcity value of savings will enable banks to pay higher deposit rates to the savers. This will lead to portfolio substitution between deposits and investments in other forms in favour of the former and augment the financial resources under the command of the monetary system. This may also augment savings. There is a general belief that savings are not sensitive to changes in the real rate of return. The negative and large coefficients of inflationary expectations variables in our modal prove that this belief is misfounded. Gupta's study also clearly suggests that deposits are sensitive to the rates paid on them.

Policies for the Supply of Money

Efficient monetary growth necessitates exogeneity of nominal money from real sectors, i.e., only one agency should command the supply of nominal money. Excessive supply of nominal money precipitates inflation and shrinks the demand for real balances. That there is strong causal relationship between the prices and growth n money supply is in no doubt. Our model in Chapter 6 also amply supports this contention.

When the supply of nominal money is not completely controlled by monetary authority, the conditions regarding the exogeneity of nominal money balances are violated. In India, for instance, the RBI has lost its control over the nominal stock of money to the government which, more often than not, resorts to deficit financing by money creation and to the commercial banks whose credit expansion during the busy seasons can be checked only with great difficulty. This situation makes the regulation of movements in the price level virtually impossible. High realized and expected rates of inflation reduce the real rates of return on money and other financial assets, induce a chain of substitution of inflation hedges for money and financial assets, of present consumption for saving, and force the economy to revert to conditions of barter and fragmented markets.

Loss of control over the stock of nominal money and its rate of growth leads to high rates of inflation and high variability in the rate. This happens especially when the government indiscriminately resorts to the monetary system to obtain resources to bridge budget deficits and banks are allowed to succumb to the increase in the damand for credit without due regard to the overall liquidity position in the economy.

A highly variable and unpredictable rate of price change encourages definancialization and leads misallocation of resources because it does not permit the public to adjust their portfolios for the imminent price rise. From this point of view, a zero rate of inflation will be the first best solution.

The second best solution will be to maintain a low rate of inflation but with narrow variability in the rate of price change to minimize damage to monetary and financial deepening. This policy may necessitate either smaller budget deficits or higher taxation. It can be argued that the inflation tax imposed by deficit financing is more indiscriminate and less equitable than direct taxes on income and indirect taxes because its incidence is heavier on the poor than on the

rich. It can also be argued that if healthy financial growth is encouraged by maintaining low and predictable rates of inflation, greater real resources will be made available to the government for its development programmes through the financial system and the need for fiscal action will be reduced.

Maintaining a low and predictable rate of inflation will also necessitate a more effective use of the instruments of monetary and credit policies to control credit expansion by banks especially during the busy seasons. An earlier section showed that as long as credit is underpriced, excess demand for funds during the busy seasons will induce commercial banks to find loopholes in the policies and directives issued by the monetary authorities and even to violate them against the danger of an impounding penalty. Adequate pricing of credit is greatly relevant in this respect too. We have argued that the real deposit rate and the real rate of return on non-monetary financial assets are the most potent instruments to deepen money and finance. The real rates of return on these assets depend upon their implicit yield, the nominal rates of return, and the expected rate of inflation. In India, the general belief about the low profitability of investments has underpriced short term and long term funds in the organized finance and resulted in low nominal deposit rates. On the other hand, the nominal stock of money has not remained exogenous to the real sectors of the economy and fairly high rate of price rise with a very high variability has occurred in the post-Independence period. (Chapter : 5) Consequently, the real rate of return on money has always remained negative and on the other on financial assets very low. The rapid absorption of financial assets is mainly because of high implicit yield on real balances and other financial assets, and the rapid magnetization and financialization of the economic activity.

The policy implications are two fold. First savings should be priced adequately not to subsidize investors at the cost of savers to prevent indiscriminate use of scarce savings, and to give correct signals to the investors about the capital-labour endowment position of the economy and encourage them to use techniques and plant sizes consistent with the factor endowments. Second, maintaining the exogeneity of nominal money from real sectors is a precondition for regulating the level and variance of inflation rate. This will enable the monetary authority to pursue a deliberate policy of supplying nominal money only in response to the demand for it. The monetary policy should primarily nourish the stock of real balances and other financial assets, and this can be done only if the monetary authority can win over the confidence of the

public in its solvency. An unanticipated inflation is viewed by the public as a default of the monetary authority and evokes the same reaction from them as does the default by any of them.

Social costs of Maintaining Financial System

On a conceptual plan, we have accepted the thesis that it is more logical to treat the monetary and financial system as an industry that consumes real resources, like capital and labour, and produces services used as inputs in the rest of the economy. On economic grounds, then, an additional investment in this industry is justified till the marginal productivity of capital in this industry becomes equal to its opportunity cost or till the net incremental welfare resulting from additional investment in financial industry remains positive. This is another major respect in which the excessive differentiation in the structure of loan windows has to be viewed with concern. In a developing economy, the problems of finding investment opportunities is not as crucial as that of mobilizing investible resources. From this point of view, the financial system can be made more efficient and socially productive by redistributing facilities created within the system among savings mobilizing institutions.

In a capital scarce economy like India, the opportunity cost of capital will be very high and the industry of finance is highly capital-intensive. A careful planning of the expansion of facilities in this industry should prove highly remunerative. Intense competition among commercial banks to set up branches in some busy areas and their reluctance to set up branches in remote rural areas is a striking example of the waste of resources in this industry. This typically results in an overcrowding of branches of various banks in busy areas with the total business getting split too finely among them and most of them working much below their capacity and on the other hand vast areas on the rural side left without any bank branch that can tap their savings potential. A close co-ordination among the banks in their expansion and planning of the geographical distribution of branches should prove fruitful. The recent move to extend banking facilities to rural areas is a commendable stop in this direction; However, In the most recent period, the situation in this regard is quite satisfactory.

Examples of the easily noticeable waste of resources in the industry of finance can be multiplied. A top-level body that can effectively keep in check, plan, and co-ordinate the new investments in this industry can help reduce the social cost of maintaining the financial system.

Financial repression as an impediment to economic development is a central paradigm. If growth takes investment, then three conditions must be met: firms (and/or the government) must be willing to invest; savings must be available; and these savings must be channeled to those who plan to invest and face the most attractive investment opportunities. The financial structure and institutions can support or disrupt this process. A repressed system, especially in conjunction with high and unstable inflation, is said to interfere in a number of ways with development: saving vehicles are underdeveloped and/or the return on saving is negative and unstable: financial intermediaries who collect saving do not allocate these saving efficiently among competing uses; and firms are discouraged from investing because poor financial policies reduce the returns or make them excessively unstable.

For the Indian economy the policy advice of maintaining positive real interest rates in the context of augmenting economic growth should give way to concerns for increased market orientation in full range of financial sector policies. As opposed to simply a mechanical insistence on positive real interest rates, the market oriented perspective stresses, among other things, the need to reduce the size of subsidies passed through the financial sector and to increase the reliance on interest rates for the mobilization and allocation of resources, paying attention not only to the real levels of rates, but to the need for differentials which reflect differences in risk, maturity and cost. In India the favourable impact of financial growth on economic development can be reinforced by encouraging the absorption of financial assets by the public and also by increasing the effectiveness of the existing financial instruments and institutions.