Chapter 7

Summary and Conclusions

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7.0 The origin of Flow of Funds analysis can be traced
to the fourth decade of the 20th century. Morris Copeland's
pioneering work "Tracing Money Flows in Capital Markets in
U.S.A." (1947), laid the foundation for the development of
Flow of Funds analysis. Flow of Funds data has been made
available for a large number of countries in recent decades.
The theory explaining the relationship between financial and
non-financial variables remains weak. The various concepts,
Quantity Theory, Liquidity Preference, Financial Intermediation,
Portfolio Choice Theories are by and large loosely linked.
A synthesis of financial variables and real variables which
the Flow of Funds was expected to provide eludes to this day.
Thus, a core theoretical base for the Flow of Funds Analysis is
yet to evolve. However, it does not detract from the analytical
value of the Flow of Funds analysis, as it represents a signifi-
cant development in the field of national income accounting and
attempts to fill the gap in the national income accounts by
incorporating the financial dimension of economic activity.

7.1 The Flow of Funds accounts supply financial data and
the analyst adapts and uses it for the purpose of understanding
the problem taken up for study. The data of Flow of Funds has
been applied for the analysis of a variety of problems, for
instance, it has been used for the study of the implications

of monetary policy, for the identification of inflation
generating sectors of the economy and the analysis of the
liquidity structure of the economy. The other important uses
of the analysis are, preparation of input-output type of finan-
cial models, short term Flow of Funds projections and construc-
tion of financial econometric models.

7.2   It is also suggested that Financial Flows could inte-
grate the real and financial variables, in a more meaningful
manner, than the rate of interest which provides a weak link
between real and financial activity.

7.3   It is observed that Flow of Capital Funds in the Indian
economy increased at the rate of 13 per cent during the period
1956-57 to 1975-76. Total Flow of Capital Funds in India has
increased from Rs. 947.2 crores in the year 1956-57 to Rs.15070.6
crores in 1975-76, at current prices. It reflects the growth
in the level of financial activity in the Indian Economy.

7.4   An attempt is made to delineate the various factors
that account for the rise in the Flow of Capital Funds; for this
purpose, a set of theoretical models are built. These models
provide insight in the interrelationships in the structures of
borrowing and lending of different sectors and their impact on
the Flows. From the models the role of financial intermediation,
cross borrowing, the degree of netness and the level of dis-
aggregation of the economy in influencing the Flow of Capital
Funds can be seen.

7.5 Further, the models highlight the relationship of Net Financial Saving and the Flows. The relationship between the Flow of Capital Funds and Net Financial Saving is found to be highly complex, as the impact of Net Financial Saving on the total Flow of Capital Funds depends on the mechanics of change in Net Financial Saving. It is observed that a mere change in Net Financial Saving will not enable us to predict the change in the direction and dimension of total Flows of Capital Funds.

7.6 The theoretical models differ from RBI form of presentation of data on Flow of Funds. RBI presents the data on Flow of Capital Funds in tabular form, whereas the theoretical models are constructed in square matrix form. This form of presentation is found to be appropriate for the analysis of structure of Flow of Capital Funds. Hence, the data has been recast in square matrix form for a period of ten years, 1966-67 to 1975-76, for which inter-sectoral Flow of Funds data is available. This form of presentation enables us to work out the coefficients of borrowing (Sources) and lending (Uses) for the Aggregate Economy as well as for the individual Sectors. The coefficients are found to fluctuate from year to year; hence, it is difficult to identify the extent and nature of structural change. In order to overcome this problem, two tools of analysis, namely, the technique of measurement of distance between vectors of coefficients of borrowing/lending and cluster analysis are used. With the help of these tools

it is possible to identify the years in which the structure
of Flow of Capital Funds changed, and the extent of oscillation
in the vectors of coefficients of borrowing and lending of
Sectors, as well as the economy.

7.7 The analysis brings out the role of different Sectors
in the changes in the structure of Capital Flows. It is found
that th structure of the Aggregate Economy's Sources and Uses
has changed from the year 1968-69. However, the change in the
structure of Sources is not as marked as the changes in the Uses.
A significant factor that accounts for the change of structure
of Sources is the relative increase in the share of Banking
Sector in the Sources of the economy. It accounts for 21 per
cent in the year 1966-67 and 32 per cent in the year 1975-76.
The change in the structure of Uses can be attributed to the
changes in the relative shares of three sectors, namely, the
Banking Sector, the Household Sector and the Rest of the World
Sector. While the shares of the first two Sectors registered
an increase, the share of the Rest of the World Sector is found
to decline from the year 1968-69.

7.8 The analysis at the Sectoral level brings out that
structural changes have occurred in the Uses of the Banking
Sector (after 1968-69) and in the Sources of the Other Financial
Institutions Sector and in the Sources and Uses of the Govern-
ment Sector from 1968-69. The degree of oscillation is found
to be very high in the structure of the Sources and Uses of the

Rest of the World Sector. The structure of the Sources of the Household Sector, the Sources and Uses of the Corporate Sector are also found to oscillate.

7.9 The Banking Sector's Sources show stability. It is found that this is due to the dominance of the Household Sector's share in its Sources. The Uses of the Household Sector are also structurally stable which is due to its preference for Deposit creation in Banking Sector and the committed nature of its savings. Thus, the structural stability of the Sources of the Banking Sector and the Uses of the Household Sector are related.

7.10 The Rest of the World Sector's interaction is mainly with the Government Sector and its share has declined from 55 per cent to 25 per cent in the Sources of the Government Sector, over the period of study.

7.11 The structure of the Sources of the Government Sector exhibits a change in the year 1968-69 coinciding with the year in which structural change has occurred in the Aggregate Economy (both in Sources and Uses). The change has occurred in the Government Sector's Sources due to a relatively higher share of the Banking Sector and a lower share of the Rest of the World Sector. This change is reflected in the Uses of the Aggregate Economy, as it implies a higher share of Banking and a lower share of Rest of the World Sector in the Uses of the Aggregate Economy.

7.12 The analysis of the Uses of the Government Sector
also shows structural change in the year 1968-69, the nature
of change being a relatively higher share of Banking Sector
and a lower share of the Household Sector in the Uses of the
Government Sector. Since the Uses of the Government Sector has
increased in the Banking Sector, the Sources of Banking from
Government Sector must also register an increase; this, in turn,
is reflected in the Sources of the Aggregate Economy in the form
of higher share of Banking in total Sources.

7.13 Thus, the analysis reveals that the importance of
Banking Sector has increased considerably in the Indian Economy
after 1968-69 which has been the main cause of structural change
at the level of the Aggregate Economy.

7.14 Another important insight that the analysis provides
is the trade off relationship between Banking and Rest of the
World Sectors in the Sources of the Government Sector. There
has been a decline in the importance of the Rest of the World
Sector in the Sources of the Government Sector, which can be
interpreted as an indicator of growing self-reliance of the
economy, as the Government's borrowing from the Banking Sector
has increased. This is one of the reasons for the increase in
the relative importance of Banking in the Aggregate Economy.

7.15 Further, it is observed that there is no trade off
in India unlike in U.S.A. in the growth of the Banking Sector

and the Other Financial Institutions Sector, as both developed
at the rates 18 per cent and 14 per cent, respectively, over
the twenty-year period 1956-57 to 1975-76.

7.16 The instrument-wise structure has been also studied
for a period of twenty years(1956-57 to 1975-76), with a view
to find out the change of preference pattern of individual
sectors for different financial instruments, as well as the
change in the importance of different instruments in the
Aggregate Economy. The conclusion that emerges from this
analysis is that the importance of Currency and Deposits has
increased in the Indian Economy though marginally from 22 per
cent to 27 per cent in the first five year period to the fourth
five year period. The most significant rise is in Bank Deposits
in the Uses of the Household Sector, where the share of Bank
Deposits in its total Uses has increased from 20.9 per cent in
the first five-year period to 45.2 per cent in the last five -
year period. This is being reflected in the Aggregate Economy's
Preference Pattern.

7.17 An attempt is made to ascertain the influence of
macro variables on the Flow of Capital Funds. For this purpose,
ordinary least squares method is used and the Flow of Capital
Funds are regressed on seven independent variables in different
combinations.

7.18 The elasticities, $\bar{R}^2$ and t values are compared; it is
found the coefficient of Money Supply is highly significant.

Money Supply has been tried as an independent variable in combination with other independent variables. It is observed that in all cases the coefficient of Money Supply turns out to be significant at 1 per cent level. The equation which is the best fit is when Money Supply, Rate of Interest and Net Financial Saving are taken as the independent variables. It can be seen from the equation that the elasticity of Money Supply is 1.3774. The logical link in these two variables is found to be in deficit financing and the increase in Demand Deposits. Demand Deposits are an important component of Money Supply and these also form an important Source of the Banking Sector. Hence, an increase in Demand Deposits has the twin effect of increasing the Flows as well as the Money Supply.

7.19 The study of the structure of Flow of Capital Funds brings out that the structure of Flows of the Aggregate Economy is relatively more stable than the structure of Flows at the sectoral level. At the Sectoral level it is found that in some sectors there has been structural change while in some others the structure oscillates. In both cases, the coefficients of lending and borrowing are not stable. Hence, Financial Planning Models based on fixed coefficients of lending/borrowing have limited value.