Chapter 1

I n t r o d u c t i o n

Chapter 1

INTRODUCTION

1.0 The relationship between the real and financial variables is one of the relatively neglected areas in macro economic theory. Till recently, the importance of financial variables in planning exercises was not explicitly recognised.

1.1 In a monetary economy the mere existence of physical resources, however large their quantum, will require the use of money to activate them. Conventionally, the function of monetary system is confined to the provision of an efficient payment mechanism which is a necessary condition for the effective functioning of an economy.

1.2 The function of the financial system is much more significant as it provides a mechanism to transfer real resources from economic units that themselves are not using these resources for investment purposes, to those units which invest and thus increase real output.

1.3 In the context of developing planned economies the role of financial system is by no means insignificant. As a result of economic development the degree of specialisation increases, the scale of production changes, small-scale of production is replaced by large-scale production, the self sufficiency of economic units as well as sectors break down. The producing units not only use as inputs the physical outputs of other units and sectors but also depend on others for financial resousrces to acquire the physical inputs from other sectors. The economy gets divided into two types of units/sectors that generate financial surpluses and those that create financial deficits. The savings of surplus units/ sectors are transferred directly to deficit units/sectors in the earlier stages of economic development and more indirectly through financial intermediaries at later stages of development.

1.4 In short, as the economy develops the Flow of Funds from different sectors through different instruments not only increases in volume but the relative shares of sectors and financial instruments in the Flows undergo changes. In the context of developing planned economies, the structure of flows of capital funds assumes special significance as the structure of flow of savings of the surplus sectors must be consistent with the targeted sectoral investments.

1.5 Thus, the role of financial system is significant as it not only mobilises the savings of the economy but ensures its optimal investment in conformity with the strategy of development.

1.6 In the Indian case, since planning is undertaken in the frame of market mechanism, though the plans are prepared in "real" terms the mobilization of financial resources to implement the plan is also important. Hence, financial requirements of the plans are worked out meticulously.

1.7 Traditionally, the problems of financial requirements of the economy were looked at from a partial angle. For a very long time, the inadequate availability of credit in the Indian Agricultural sector was recognised as an important factor for its backwardness. The attempts to develop the co-operative movement to provide the institutional arrangements for the supply of credit to this sector can be traced to the beginning of the present century. The appointment of Rural Credit Survey Committee in 1952 and its elaborate recommendations for the development of Cooperative Institutions is a reflection of the role of finance in agricultural development.

1.8 The lack of industrial finance was another aspect of the problem of inadequate savings and the lack of proper legal and institutional arrangements to ensure the transmission of savings, for industrial investment.

1.9 Research in this field in India has been mainly confined to an analysis of the structure and defects of money and capital markets.

1.10 The development of Flow of Funds Analysis provided, for the first time, an opportunity to look at the problem of financing economic activity from the macro angle.

1.11 The Present Study: In this study the financial structure of the Indian economy is examined in the frame of Flow of Funds Analysis. An attempt is made to examine the hypothesis that as an economy develops financial structure undergoes changes.

1.12 Financial structure may mean, (a) Institutional Structure, (b) Composition of Assets and Liabilities (Stocks, (c) the Share of different sectors in the Flow of Total Capital Funds (Total Financial Assets/Liabilities) in the economy, as well as the disposition of individual sectors' asset creation among other sectors and the acquisition of individual sectors' liabilities from other sectors.

1.13 It must be noted that (c) is essentially a Flow of Funds concept. In this study the emphasis is on the analysis of the structure of Flows of Capital Funds in the Indian economy.

1.14 Chapter 2 : In this chapter a review of bench mark studies and literature on the subject of Flow of Funds is undertaken.

1.15 Chapter 3: This chapter presents a framework for the analysis of structure of inter-sectoral flows. In order to understand the internal mechanics which determine the magnitude of the Capital Flows, a set of hypothetical models are constructed in this chapter, which highlight the elements that influence the Flows, elements such as number of of sectors, cross borrowing, and financial intermediation, etc. Further, the relationship between the net financial savings and the flows are also examined with the help of these models.

1.16 The Indian data has been recast in the framework of square matrices for a period of ten years, i.e., 1966-67 to 1975-76. This forms the basis of study of inter-sectoral structure of Flow of Capital Funds in the next chapter.

1.17 Chapter 4: The structure of Flow of Capital Funds of the Indian economy for the period 1966-67 to 1975-76 is examined in this chapter. The format of presentation of data discussed in Chapter 3 enables us to work out the coefficients of lending/borrowing of the economy and of individual sectors. The technique of measurement of distance between the vectors is used to calculate the distance between the vectors of coefficients of lending as well as borrowing, for all the ten years. Distances are calculated making each year as the base in succession. Based on these distances cluster analysis is undertaken. Cluster analysis enables us to identify the years which are structurally close and those which are structurally distant. As the coefficients of lending and borrowing are "volatile" the use of the technique of cluster analysis is essential to bring out the nature and extent of change in the structure of Flows in the Indian Economy.

1.18 Chapter 5: In this chapter the total Flows have been looked at from the angle of relative shares of various instruments constituting the Flows. This approach brings out changes in the relative importance of various Financial Instruments. Further, structure of the Flows is analysed through a study of ratios of secondary and primary issues in the Financial Flows. Such a study reveals the changes in the level of Financial intermediation.

1.19 Chapter 6: An attempt is made in this chapter to measure the relationship between the macro variables and Flow of Capital Funds. The variables examined are Net National Product, Net Domestic Savings, Net Capital Formation, Net Financial Savings, Rate of Interest, Price Index and Money Supply.

1.20 Chapter 7: This chapter presents an overall summary of the work and conclusions.

1.21 The Data Base: Reserve Bank of India (RBI) prepares the Flow of Funds data for the Indian Economy and publishes the data in its Bulletins from time to time. These Bulletins for various years, from 1967 to 1980, are the main sources of data for the major part of the work. Supplementary data on macro variables of the economy are drawn from CSO publications and other published sources.