IMPLICATIONS OF INTERLINKAGES BETWEEN GROWTH OF FINANCIAL SECTOR AND ECONOMIC DEVELOPMENT FOR INDIAN BUSINESS

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The financial sector promotes economic development by enabling the transfer of financial resources in an economy from those whose expenditures are less than their incomes to those whose incomes are less than their expenditures. However, the process of economic development, i.e. the growth of the real sector, itself leads to an expansion of the financial sector in the economy. This clearly suggests that the relationship between financial and economic development is one of interdependence rather than a one-way causality. Thus, a deeper analysis of the possible interlinkages that are likely to exist between the growth of the financial sector and economic development could provide useful insights for policy making, especially in the Indian economy wherein the planners and policy makers are gradually realising that the programme of economic reforms undertaken in recent years cannot reach its logical culmination till the requisite reforms in the financial sector are also carried out. It is against this backdrop that the present paper finds the liberalisation of the financial sector as a necessary condition for the success of trade and industrial sector reforms and advocates a policy of gradual deregulation of interest rates as the most prudent step for the growth of business and corporate sector in India.

I. INTRODUCTION

The financial sector acts as a link between savers and investors and thereby promotes economic development by bringing together the supply of savings and the demand for investible funds in an economy. The activity of saving is largely diffused across millions of individual households who lack the skill, capacity and temperament for active investment. In contrast, the act of investment is mainly confined to a special class of entrepreneurs and businessmen who possess the requisite competence but generally lack enough funds of their own to make the desired investments and hence are on the whole net deficit spenders. Thus, by meeting the credit needs of entrepreneurs, the financial sector could significantly contribute towards promoting business activity and thereby capital formation in the economy.

Apart from the availability of institutional credit, it is equally important from the perspective of business and corporate sector that the cost of loans in terms of the interest rate be determined in the most expedient manner. This calls for utmost efficiency in the functioning of financial markets, especially in the case of a developing economy such as India wherein after the establishment of a proper financial

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infrastructure in a recent years, the focus of planners and policy makers has now shifted towards reforming the financial sector as is evident in the recommendations of both the Chakravarty Committee (1985) and the Narasimham Committee (1991) appointed by the Government of India.

One possible alternative before the monetary authority with a view to achieving greater efficiency in the financial sector is to pursue a policy of financial liberalisation, including the deregulation of interest rates. But since the monetary and credit policies of the government play a major role in the shaping of the overall environment in which business activity takes place, it is essential to explore if a sufficient degree of analytical and empirical support exists in favour of such a policy option in the case of Indian economy. Towards this end, it becomes imperative to study the analytics of financial growth and economic development which could, in turn, provide useful insights into the efficiency aspects of financial markets, so crucial for effective policy making in India.

Against this backdrop, the purpose of the paper is to analyse the interlinkages between the growth of the financial sector and economic development in the case of Indian economy and thereby suggest a suitable policy package for the growth of business and corporate sector in India.

II. ANALYTICS OF FINANCIAL GROWTH AND ECONOMIC DEVELOPMENT

The interlinkages between economic development and the growth of the financial system have gained an increasing degree of importance in the field of development economics, especially after the pioneering work of Gurley and Shaw (1960). Their approach to economic development attached greater significance to money and finance and highlighted the role of the financial sector in stimulating capital formation via the transfer of financial surpluses in the economy from surplus units to the deficit spenders and productive investors.

Inspired by the work of Gurley and Shaw, several other development economists, particularly Patrick (1966) and Goldsmith (1966) tried to analyse the relationship between financial development and economic growth and suggested the possibility that the growth of the real sector could itself facilitate the growth of financial sector in an economy. Thus, it became the subject matter of a continuing debate whether the growth of the financial sector is a cause or, in fact, an inevitable consequence of economic development. Even the later studies by Fry (1980) and Gupta (1984) that tried to explore this issue empirically also found a two way causality between the growth of financial sector and real sector in an economy thereby indicating the *interdependence* between financial and economic development.

In addition to this controversy about the direction of causality, there are marked differences of opinion among development economists over the transmission mechanism whereby financial conditions could affect economic growth and development. Broadly, two viewpoints emerge in economic literature as regards the role of the financial sector in the growth of a developing economy. The first view may be described as *'financial structuralist'* as advanced by Goldsmith (1969) which maintains that growth of financial institutions and diversification of financial instruments would stimulate both savings and investment and thereby economic growth. The second view may be described as *'financial repressionist'* as expounded by McKinnon (1973) and

Shaw (1973) which proclaims that the real rate of interest as the return to savers is the key to a higher level of investment and as a rationing device to greater efficiency. Ceilings on nominal rates of interest in face of high and variable rates of inflation would, therefore, give rise to financial repression which acts as an impedient to finacial deepening, capital formation and economic growth.

The policy implication of the repressionist view is that all limits of ceilings on interest rates be lifted and financial markets be made free and competitive.

Within the broader framework of financial repression, the models of finance in economic development separately formulated by McKinnon and Shaw were based on different underlying mechanisms whereby real rate of interest could affect savings and economic growth. As opposed to McKinnon's approach which relied on the so-called *'conduit effect'* that signified the complementarity between real cash balances and real capital formation, under Shaw's *debt intermediation thesis* such a complementarity had no place as investors were not constrained to self finance.

The repressionist view stressing the importance of financial conditions in the development process of an economy was also supported empirically by Fry (1978). Using the data on seven Asian less developed countries including India, Fry established that the real rate of interest has a positive effect on the domestic saving and economic growth. The relevant results of pooled-regression obtained in the concerned study, however, did not support McKinnon's *'Complementarity hypothesis'* which was, therefore, rejected by Fry in favour of Shaw's debt-intermediation view. In sharp contrast, using annual data for India over the period 1964-84, Thornton (1989) found strong support for McKinnon's complementarity hypothesis both in the demand for money as also saving functions in his study.

III. APPROPRIATE POLICY PACKAGE FOR THE GROWTH OF BUSINESS AND CORPORATE SECTOR IN INDIA

In the face of a severe crisis on the macroeconomic front, the Indian economy started off with a massive programme of '*economic reforms*' in July 1991 which was aimed at promoting competition and raising production efficiency via privatisation and liberalisation measures. The concerned policy reforms practically touched upon almost all aspects of the real sector, be it industry, trade, exchange rate or foreign investment.

To a considerable extent these economic reforms succeeded in fulfilling their immediate purpose, viz., effectively tackling the short-term macroeconomic crisis. For instance, owing to the economic reforms initiated by the government, the balance of payments situation of the Indian economy stabilised, accumulation of foreign exchange reserves increased, fiscal deficit was substantially cut down so that excessive inflationary tendencies were contained and the rate of industrial growth picked up.

But apart from rectifying the severe macroeconomic crisis in the short term, the process of economic reforms in India was chalked out with a broader and long-term perspective of bringing about a market-orientation in the economy with a view to boosting the growth of business and corporate sector in India in order to enhance the overall rate of growth of the economy.

In this connection, however, it was realised of late that the progress of the business and

corporate sector crucially hinges on the efficacy of the financial sector in the economy. The rationale underlying this contention is the fact that on account of the increasing complexity of the economic activity associated with a rapid modernisation and upgradation of production technology in recent years, the average investment required for any business venture has become so large that no single entrepreneur can be expected to finance it from his personal sources. Thus, for meeting his need for funds, any businessman or entrepreneur in the contemporary context has to necessarily seek recourse to the financial sector which provides financial resources in the form of *institutional credit* at some mutually agreeable rate of interest.

It is worth noting in this context that apart from the government, the main source of institutional credit in an economy comes from the individual savings of the innumerable households which are mobilised by the financial sector by offering them a wide variety of financial assets with attractive combinations of income, safety and yield to suit their needs and preferences.

Evidently, applying the *theory of liquidity preference*, it would directly follow that a potential saver would not be forthcoming to invest his savings in financial assets till the real rate of interest, i.e. the expected real return, following from such an investment is perceived to be reasonable by him.

It must be pointed out that according to *Fisher's equation*, the real rate of interest on any financial asset (r) is given by the difference between the nominal rate of interest (i) and the expected rate of inflation ($\dot{p}^e$). Mathematically, $r = i - \dot{p}^e$ which clearly suggests that in case the nominal rate of interest (i) on financial assets such as deposits is administratively kept too low while inflationary tendencies continue to gain momentum in the economy so that the expected rate of inflation ($\dot{p}^e$) is too high, then the real rate of interest (r) would be quite low. In the extreme case when $\dot{p}^e$ exceeds i, the real rate of return on deposits could even be negative which acts as powerful disincentive for savers to go in for financial investments. As a result, there will be a misdirection of economy's financial surpluses in socially undersirable directions like bullion, gold and silver ornaments, real estate, speculative hoarding of essential commodities and other such socially unproductive activities so much so that the genuinely desirable business activity and productive investments will suffer for want of funds. Such a situation wherein on account of the interest rates being administratively fixed below their equilibrium levels, there is a lesser degree of financial intermediation between savers and investors in the economy, was referred to as '*financial repression*' by McKinnon and Shaw.

This is precisely what has actually been happening under the system of *administered interest rates* that prevailed in the Indian economy till very recently. More specifically, the provision of institutional credit at concessional rates to the *priority sectors* such as agriculture, small-scale industries, economically weaker sections, etc. was cross-subsidised by charging higher rates of interest from borrowers belonging to the other sectors especially the business and corporate sectors. Side by side, in order to further compensate for the concessioinal lending to the priority sectors, the interest rates on deposits were deliberately kept at artificially low levels through administrative fiat which, in turn, led to a tremendous leakage of funds from the institutional and organised sections of the financial system towards the unorganised segments and socially harmful activities. Such a scenerio not only created

obstacles in the conduct of the official monetary and credit policies of the Reserve Bank of India but also resulted in a serious shortage of financial resources being experienced by the legitimate and deserving business activites in the Indian economy.

In the light of all these developments, it was widely recognised that the business and corporate sector in India could only flourish if the economic reforms pertaining to the real sector of the Indian economy such as the liberalisation of industry and trade were also suitably supplemented by a corresponding liberalisation of the financial sector. In particular, the planners and policy makers felt that it was only through the *deregulation of interest rates* that financial repression would be given a go by thereby curing the major distortions in the financial sector of the Indian economy.

At the same time, however, it was also realised that such a policy of interest rate liberalisation shall be introduced in a step-by-step and phased manner rather than entirely leaving it to be determined by the free interplay of market forces all of a sudden. The latter course was not chosen as it could have led to an abrupt and sharp increase in the interest cost burden on the small borrowers apart from raising the *risk of default* by causing an adverse selection of projects. Evidently, if the institutional credit-worthiness and as a result the default rate on official loans rises, then there would be little rechannelisation of bank funds which could have serious and far-reaching repurcussions in the society thereby threatening the very viability of the financial system itself.

Keeping all these considerations in mind, the following major *interest rate reforms* aimed at boosting the growth of business and economic activity were carried out by the monetary authority in India during 1991-92 to 1996-97 : (1) Interest rate on bank loans above Rs. 2 lakhs have been fully decontrolled. The number of administered interest rates on bank advances have been reduced from 20 in 1989-90 to 2 in 1994-95; (2) Interest rate on domestic bank deposits above one year maturity and on NRER deposits above two years has been decontrolled in 1996; (3) Interest rates on deposits and advances of all co-operative banks (except urban co-operative banks) have been deregulated subject to a minimum lending rate of 12 per cent; (4) Interest rates on advances of primary co-operative banks have also been deregulated subject to a minimum lending rate of 13 per cent; and (5) The prime lending rate of the State Bank of India and most other banks on general advances over Rs. 2 lakhs has come down by 2.5 percentage points to 16.5 per cent between 1991-92 and 1995-96.

All the above mentioned policy measures can be reasonably expected to go a long way in imparting a fair degree of competitiveness and dynamism in the Indian financial system thereby promoting the growth and development of the business and corporate sector in India.

IV. SCOPE FOR FURTHER RESEARCH

As amply demonstrated above, the relationship between financial growth and economic development has so far been analysed mainly in terms of financial structuralist and financial repressionist approaches in the contemporary economic literature. The structuralist view is primarily attributable to Goldsmith (1996 and 1969) whereas the repressionist view was chiefly advanced by McKinnon (1973) and Shaw (1973) in their separate works using different lines of reasoning.

Thus, it is important to analyse as to which of the prevailing approaches is more suitable to explain the Indian development experience. In this context, it is quite conceivable that some modifications might be warranted in the existing models of finance in economic development when applied to the case of Indian economy.

Moreover, the contrasting results of the relevant empirical studies as mentioned in the foregoing review of literature clearly suggest that the issue of financial repression and its underlying dynamics needs further investigation, particularly in the Indian case wherein due to inflationary pressures, real rates of interest have been at times even negative as observed by Pandit (1991). In this context, a detailed analysis of the saving behaviour and asset choice of Indian households also becomes necessary in view of the main findings of Pandit's study that despite negative real rates of interest household savings have remained steady in India and that the households have not been deterred from choosing financial assets as a medium of savings in the Indian economy.

In order to have a clear and comprehensive view of the issue at hand, it is, in fact, essential to lay due emphasis both on the forward as well as backward linkages between financial and economic development. In particular, the relatively unexplored aspects of the manner in which economic development could propell the growth of the financial sector deserves to be paid more attention in terms of futher theoretical and empirical analysis using the data relating to the Indian economy. Such an analysis would be helpful in establishing the extent to which the financial development in India has been '*supply leading*' or '*demand following*' and could offer useful insights as to how the concerned pattern has varied over time in accordance with different stages of economic development being achieved by the Indian economy.

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