UNIT IV

Liquidity Theory of Money by Radcliffe: Statement, Radcliffe Report and Evaluation | Economics

Statement of the Theory:

During the 1950's, the publication of Radcliffe Committee's Report in England and the work by Gurley and Shaw in the United States questioned the adequacy of existing monetary theory to serve as a guide for monetary policy and led to the development of a new theory, called liquidity theory of money.

According to the new approach, the causal relation between money and the volume of economic activity or the general price level cannot be explained under the modern conditions either by the classical quantity theory or by the Keynesian income theory, but by the role played by the whole structure of liquid assets which can serve as a substitute for money to satisfy the liquidity desire of the public.

In view of the easy substitutability between money and wide range of financial assets, also called near- moneys (such as time deposits, various money market instruments like bills of exchange, treasury bills, gilt- edged securities, cash surrender values of life insurance policies, saving bonds, deposits of building societies, deposits of saving and other banks, postal saving deposits, and all credit instruments of the financial sector of the economy), in modern times, the quantity of money gets a secondary role and the liquidity of the economy assumes more significant position in the monetary analysis.

Besides the banking sector, a good deal of liquidity is created by the non-bank financial intermediaries, such as insurance companies, saving banks, building societies, etc., which provide liquid assets in exchange for short-term and long-term claims on the private and public sector of the economy. These financial intermediaries, by increasing the liquidity in the economy cause the velocity of money and, in turn, expand general business activity.

Thus, the traditional monetary policy which influences only the total volume of money supply and not the total volume of liquidity in the economy (which is much more than the money supply) is inadequate and ineffective because aggregate spending is influenced not only by the currency and the bank deposits but also by the near-money assets as created by the non-bank financial institutions. Since the new theory holds that non-bank financial institutions can frustrate the conventional monetary policy by altering the velocity (liquidity) of money, an appropriate definition of money must include the liabilities of non-bank financial institutions.

Gurley and Shaw suggest a liquidity definition of money in which money is regarded as "a weighted sum of currency and demand deposits and substitutes with weights assigned on the basis of the degree of substitutability ranging from one to zero". The more imperfect substitute, the less the weight.

Radcliffe Report:

Radcliffe Committee was appointed by British Chancellor of Exchequer in 1957 to inquire into the working of monetary and credit system and to make recommendations. The Report of the Committee was published in August 1959.

Various findings and recommendations of the Radcliffe Report are as follows:

I. Classical Direct Mechanism Criticised:

While investigating the way in which money influences the economic activity, the Report criticised the direct mechanism (as embodied in the Equation of Exchange, MV = PT) of the classical quantity theory of money on the following grounds:

(a) No tight relationship was found between the supply of money (as defined in the classical theory) and the level of economic activity (national income),

(b) In a highly developed financial system with many financial intermediaries, grave theoretical difficulties were faced to identify or label some quantity as 'the supply of money',

(c) The Committee could not find any reason or historical evidence for believing the velocity of money to be stable or constant. The Committee considered the velocity of money as a numerical constant devoid of any behavioural content and as a variable whose value changes as the definition of money was altered.

II. Velocity of Money Indeterminate:

The Committee also observed that in a system of highly developed financial intermediaries providing substitutes for narrowly defined money, the velocity of circulation was indeterminate. If the central bank wanted to restrict the growth of aggregate demand (MV) by restricting the growth of money supply (M), the non-bank financial intermediaries were able to activate demand deposits and currency, thus raising velocity (V) sufficiently to offset the restrictions on the money supply and, thereby, leaving the aggregate demand (MV) largely unaltered.

III. Keynesian Indirect Mechanism Criticised:

The Committee also found no empirical evidence for the Keynesian indirect mechanism. According to the Committee, (a) it found no evidence that higher interest rates reduced consumption; (b) there was no indication that interest rates were important to large firms with respect to investment in either inventories or fixed capital; (c) Expenditures of the nationalised industries and of local authorities were also largely impervious to changes in interest rate; (d) the smaller firms treated the interest rate effect with skepticism. Thus, in the words of Radcliffe Report, "as the system works at present, changes in the rates of interest only very occasionally have direct effects on the level of demand."

IV. Definition of Liquidity:

The Radcliffe Report considered the impact of money supply on economic activity through its influence on the overall level of liquidity. Liquidity is not limited by the amount of money in

existence. It consists of the amount of money people think they can get hold of, whether by receipt of income, by disposal of capital asserts, or by borrowing.

The report distinguished between the old liquidity and the new liquidity. Old liquidity refers to the amount of money people think they can get hold of from their own resources, while new liquidity relates to the amount of money people think they can get hold of from unused borrowing power.

V. Transmission Mechanism:

The Radcliffe report outlined a new transmission mechanism explaining the influence of the money supply on the pace of economic activity. Liquidity plays an important role in this transmission mechanism.

There are two elements in the transmission mechanism:

(i) The first element relates to the relation between liquidity and expenditures. If liquidity is reduced, expenditure (to the extent they exceed current income) ought to decline and vice versa.

(ii) The second element relates to the way the money supply can influence the level of liquidity and hence the level of expenditures.

Conventional monetary contraction, for example, raises interest rates, which, in turn produces two effects:

(a) Rising interest rates reduce the old liquidity of the spenders because the capital value of these assets is reduced,

(b) Rising interest rates-also reduce the new liquidity.

The capital value of assets held by the financial institutions is reduced as a result of rising interest rates. This reduces their ability to lend, thus making it more difficult for the individuals to acquire new liquidity.

According to the Radcliffe Report, it is the increasing difficulty of acquiring new liquidity that is the major effect of the monetary policy and this difficulty has its impact on the ability of the lenders to lend and not on the ability of borrowers to borrow.

Thus, while the tight monetary policy and the resultant rising interest rates have little effect on the demand for loanable funds, they reduce the supply of loanable funds. And since the individuals cannot acquire funds (or new liquidity), they tend to reduce their expenditures.

VI. Policy Implications:

The new transmission mechanism, as suggested in the Radcliff Report, indicates that the structure of interest rates is the centre piece of monetary action and the money supply is an important means to influence the structure of interest rates. Banks occupy a special position because they are the most convenient institutional sources of borrowing funds. But, according to the Radcliffe Report, all this does not mean that the monetary measures are the most effective measures and should alone be relied upon.

As regards the stabilisation policy, the committee has the following recommendations:

(a) Greater reliance should be on the fiscal policy, and the monetary policy should play a subordinate part in guiding the development of the economy.

(b) In extraordinary times, direct measures to influence liquidity, such as control of capital issues, bank advances, consumer credit should be taken.

(c) The Committee rejects the controls over the lending capacity of non-bank financial intermediaries because of additional administrative burdens.

2. First Narasimhan Committee Report – 1991

To promote the healthy development of the financial sector, the Narasimhan committee made recommendations.

Recommendations of Narasimhan Committee

1. Establishment of 4 tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at the top and at bottom rural banks engaged in agricultural activities.

2. The supervisory functions over banks and financial institutions can be assigned to a quasi-autonomous body sponsored by RBI.

3. A phased reduction in statutory liquidity ratio.

4. Phased achievement of 8% capital adequacy ratio.

5. Abolition of branch licensing policy.

6. Proper classification of assets and full disclosure of accounts of banks and financial institutions.

7. Deregulation of Interest rates.

8. Delegation of direct lending activity of IDBI to a separate corporate body.

9. Competition among financial institutions on participating approach.

10. Setting up Asset Reconstruction fund to take over a portion of the loan portfolio of banks whose recovery has become difficult.

Banking Reform Measures of Government: –

On the recommendations of Narasimhan Committee, following measures were undertaken by government since 1991: –

1. Lowering SLR and CRR

- The high SLR and CRR reduced the profits of the banks. The SLR had been reduced from 38.5% in 1991 to 25% in 1997. This has left more funds with banks for allocation to agriculture, industry, trade etc.
- The Cash Reserve Ratio (CRR) is the cash ratio of banks total deposits to be maintained with RBI. The CRR had been brought down from 15% in 1991 to 4.1% in June 2003. The purpose is to release the funds locked up with RBI.

2. Prudential Norms: –

- Prudential norms have been started by RBI in order to impart professionalism in commercial banks. The purpose of prudential norms includes proper disclosure of income, classification of assets and provision for Bad debts so as to ensure that the books of commercial banks reflect the accurate and correct picture of financial position.
- Prudential norms required banks to make 100% provision for all Non-performing Assets (NPAs). Funding for this purpose was placed at Rs. 10,000 crores phased over 2 years.

3. Capital Adequacy Norms (CAN): –

- Capital Adequacy ratio is the ratio of minimum capital to risk asset ratio. In April 1992 RBI fixed CAN at 8%. By March 1996, all public sector banks had attained the ratio of 8%. It was also attained by foreign banks.

4. Deregulation of Interest Rates

- The Narasimhan Committee advocated that interest rates should be allowed to be determined by market forces. Since 1992, interest rates have become much simpler and freer.
- Scheduled Commercial banks have now the freedom to set interest rates on their deposits subject to minimum floor rates and maximum ceiling rates.
- The interest rate on domestic term deposits has been decontrolled.
- The prime lending rate of SBI and other banks on general advances of over Rs. 2 lakhs has been reduced.
- The rate of Interest on bank loans above Rs. 2 lakhs has been fully decontrolled.
- The interest rates on deposits and advances of all Co-operative banks have been deregulated subject to a minimum lending rate of 13%.

5. Recovery of Debts

- The Government of India passed the “Recovery of debts due to Banks and Financial Institutions Act 1993” in order to facilitate and speed up the recovery of debts due to banks and financial institutions. Six Special Recovery Tribunals have been set up. An Appellate Tribunal has also been set up in Mumbai.

6. Competition from New Private Sector Banks

   - Banking is open to the private sector.
   - New private sector banks have already started functioning. These new private sector banks are allowed to raise capital contribution from foreign institutional investors up to 20% and from NRIs up to 40%. This has led to increased competition.

7. Access To Capital Market

- The Banking Companies (Acquisition and Transfer of Undertakings) Act was amended to enable the banks to raise capital through public issues. This is subject to the provision that the holding of Central Government would not fall below 51% of paid-up-capital. SBI has already raised a substantial amount of funds through equity and bonds.

8. Freedom of Operation

- Scheduled Commercial Banks are given freedom to open new branches and upgrade extension counters, after attaining capital adequacy ratio and prudential accounting norms. The banks are also permitted to close non-viable branches other than in rural areas.

9. Local Area Banks (LABs)

- In 1996, RBI issued guidelines for setting up of Local Area Banks, and it gave Its approval for setting up of 7 LABs in private sector. LABs will help in mobilizing rural savings and in channelling them into investment in local areas.

10. Supervision of Commercial Banks

- The RBI has set up a Board of financial Supervision with an advisory Council to strengthen the supervision of banks and financial institutions. In 1993, RBI established a new department known as Department of Supervision as an independent unit for supervision of commercial banks.

Narasimham Committee Report II – 1998

In 1998 the government appointed yet another committee under the chairmanship of Mr Narsimham. It is better known as the Banking Sector Committee. It was told to review the banking reform progress and design a programme for further strengthening the financial system of India. The committee focused on various areas such as capital adequacy, bank mergers, bank legislation, etc.

It submitted its report to the Government in April 1998 with the following recommendations.

1. **Strengthening Banks in India** : The committee considered the stronger banking system in the context of the Current Account Convertibility 'CAC'. It thought that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the

light of CAC. Thus, it recommended the merger of strong banks which will have 'multiplier effect' on the industry.

2. **Narrow Banking** : Those days many public sector banks were facing a problem of the Non-performing assets (NPAs). Some of them had NPAs were as high as 20 percent of their assets. Thus for successful rehabilitation of these banks, it recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in the short term and risk-free assets.
3. **Capital Adequacy Ratio** : In order to improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity also. Currently, the capital adequacy ratio for Indian banks is at 9 percent.
4. **Bank ownership** : As it had earlier mentioned the freedom for banks in its working and bank autonomy, it felt that the government control over the banks in the form of management and ownership and bank autonomy does not go hand in hand and thus it recommended a review of functions of boards and enabled them to adopt professional corporate strategy.
5. **Review of banking laws** : The committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc. This up gradation will bring them in line with the present needs of the banking sector in India.

Apart from these major recommendations, the committee has also recommended faster computerization, technology up gradation, training of staff, depoliticizing of banks, professionalism in banking, reviewing bank recruitment, etc.

https://www.civilsdaily.com/

Meaning of Financial Intermediaries (FIs):

Financial intermediaries (FIs) are financial institutions that intermediate between ultimate lenders and ultimate borrowers. Funds flow from ultimate lenders to ultimate borrowers either directly or indirectly through financial institutions.

FIs are commercial banks, cooperative credit societies and banks, mutual savings banks, mutual funds, savings and loan associations, building societies and housing loan associations, insurance companies, merchant banks, unit trusts, and other financial institutions.

FIs are divided into:

(a) Commercial banks; and

(b) Non-bank financial intermediaries (NBFIs).

The essential function of FIs is to satisfy simultaneously the portfolio preferences of two types of individuals or firms. On the one side are borrowers who are non-financial (deficit) spending units. Their principal function is to produce and purchase current output and not to buy one type of security by issuing another, according to Gurley and Shaw.

They wish to expand their holdings of real assets like inventories, real estate, plant and equipment, etc. They finance these by issuing what Gurley and Shaw term primary securities

which they define as “all liabilities and outstanding equities of non-financial spending units.” They are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities. On the other side are lenders (surplus income units or savers) whose assets are in the form of bank deposits, insurance policies, pensions, etc.

FIs transfer funds from ultimate lenders to ultimate borrowers. They acquire the savings of surplus income units and offer in return claims on themselves. They also purchase primary securities from non- financial spending units by the creation of claims on themselves through indirect or secondary securities.

Thus FIs issue secondary securities. They are currency issued by the central bank, demand and time deposits of commercial banks, and savings deposits, insurance and pension funds of nonmonetary intermediaries. FIs are, therefore dealers in securities.

They purchase primary securities and sell their secondary securities. Thus FIs function as dealers by buying funds from ultimate lenders in exchange for their own secondary securities and selling funds to ultimate borrowers in exchange for the Iatter,s primary securities. The purchase of primary securities by surplus income units is called direct finance and by financial intermediaries as indirect finance. Both primary and secondary securities are referred to as financial assets.

Process of Intermediation:

When the distribution of income among the spending units is exactly the same, all units have balanced budgets on income and product account. When income and spending distributions differ, some spending units have surpluses while others have an equivalent amount of deficits.

Surplus units (ultimate lenders) supply options on current output equal to their surpluses and, in return, acquire an equal amount of net financial asset i.e. financial assets less debt increased and equities issued. Deficit units (ultimate borrowers) take up and exercise these options paying for them by increasing their net debt and equity. These budget imbalances normally lead to net issues of primary securities and net accommodation of financial assets.

First we take intermediation by the commercial banks or the monetary system. When the commercial banks intermediate, the ultimate borrowers sell them their primary securities and receive money in demand deposits of banks. These demand deposits are then spent by the borrowers for current output. The ultimate lenders acquire financial assets which represent the options on current output they have realised from the borrowers through bank deposits.

In this process of intermediation, ultimate borrowers have created primary securities, the banks have created money by purchasing them, and ultimate lenders have acquired financial assets as a reward for not spending. Unspent incomes have been transferred from surplus to deficit units through bank intermediation.

Now take intermediation by NBFIs. When the ultimate lenders having demand deposits with banks, write cheques and present them to NBFIs, they, in return, receive claims on these intermediaries. NBFIs endorse the cheques and send them to the banks having demand deposits. They use these deposits to purchase primary securities from ultimate borrowers.

The latter now have the demand deposits which they spend for current output, and are eventually received by ultimate lenders. The ultimate lenders end up with the same amount of demand deposits that they started with but now they have more of financial assets which represent unspent income they have transferred to the ultimate borrowers.

In this intermediation process, the borrowers have again created primary securities, NBFIs have created secondary securities, and the lenders have acquired financial assets. The nominal size of the monetary system measured by assets or liabilities has not changed.

The bank deposits have been transferred from ultimate lenders to NBFIs, then to ultimate borrowers, and finally back to the ultimate lenders. There has been no intermediation by the banking system, its role has been that of administering the payment mechanism of transferring demand deposits on to its ledgers. Thus both commercial banks and NBFIs intermediate in the transfer of unspent income from surplus to deficit units.

Roles of Financial Intermediaries:

1. Role in the Modern Financial System:

Financial intermediaries play an important role in the modern financial system and benefit the economy as a whole.

They have the following economic effects:

(i) Reduce Hoarding:

By bringing the ultimate lenders (or savers) and ultimate borrowers together, FIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

(ii) Help the Household Sector:

The household sector relies on FIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

(iii) Help the Business Sector:

FIs also help the non-financial business sector by financing it through loan's, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

(iv) Help the State and Local Government:

FIs help the state and local bodies financially by purchasing their bonds.

(v) Help the Central Government:

Similarly, they buy and sell central government securities and thus they help the central government.

(vi) Lenders and FIs both Earn:

When savers deposit their funds with FIs, they earn interest. When FIs lend to ultimate borrowers, they earn profits. In fact, the' reward of intermediation arises from the difference

between the rate of return on primary securities held by FIs and the interest or dividend rate they pay on their indirect debt.

(vii) Spread of Risks:
FIs possess greater resources than individuals to bear and spread risks among different borrowers. This is because of their large size, diversification of their portfolios and economies of scale in portfolio management. They can employ skilled portfolio managers and other financial experts.

They also benefit by exploiting economies of scale in lending and borrowing. On the lending side, they can invest and manage investments in primary securities at unit costs far below the experience of most individual lenders.

The large size of their portfolio permits a significant reduction in risks through diversification. The maturity of primary securities can be phased in such a manner that liquidity crises are minimised. Similarly, on the borrowing side, since the number of depositors is very large, FIs can spread the repayment schedule over a longer time period and can reduce the illiquidity of their portfolios.

There are also external economies associated with FIs. External economies are particularly evident in the case of the monetary system. An efficient monetary system is an essential condition for the real growth in the economy. External economies are also important in the case of social and private insurance, and of mortgage and consumer finance.

(viii) Creation of New Assets and Liabilities:
All FIs create financial assets. The banks create money when they purchase primary securities. Other intermediaries create various forms of non-monetary indirect assets when they deposit money. Non-financial spending units create primary securities. In each case, the financial asset is created by the purchase of another financial asset or by the purchase of tangible assets.

Banks purchase various types of primary securities. They create money in an amount which is the multiple of primary securities they hold. NBFIs initially purchase currency and demand deposits when they create indirect securities. In the same way, these intermediaries create liabilities by some multiple of either their currency or deposit balance. Since they can sell money for primary securities, they can create liability by some multiple of any type of asset they hold.

Prof. Gardner Ackley has shown that in intermediation between ultimate savers and direct investors, FIs add greatly to the stock of financial assets available to savers. For every extra asset, they also create an equal new financial liability. Since FIs also own each others' liabilities, they create increments of assets and liabilities. Still, intermediation does not affect total net worth. He concludes that although the increment of assets and liabilities does not increase total wealth or income, we can assume that it increases welfare.

(ix) Provide Liquidity:

FIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When FIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity.

This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

(x) Help in Lowering Interest Rates:
Competition among FIs leads to the lowering of interest rates. FIs prefer to keep their savings with FIs rather than in cash. The FIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall.

Moreover, when people keep their cash holdings with FIs which are safe and liquid, the demand for money falls thereby lowering interest rates. This can be illustrated diagrammatically in Fig. 1. The supply of money is given, as shown by the vertical curve MS. The demand for money is shown by the curve MD. When FIs shrink the demand for money, the curve MD shifts to M,D, and consequently the interest rate falls from r to r_1

Patikin has shown in his Money, Interest and Prices (1965) that when the interest rate is influenced by FIs, it, in turn, affects the price level of the economy. The greater this effect is, the smaller will be the effect of FIs on the interest rate.

(xi) Low Interest Rates Benefit both Savers and Investors:
When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also reduced which induces savers to deposit their funds with FIs even though the latter pay lower interest rates.

Still the savers benefit because FIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

(xii) Bring Stability in the Capital Market:
FIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no FIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market.

As FIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services. In fact, the extensive regulation under which FIs operate in advanced countries like the United States has reduced the threat of stock scam, as it occurred in India.

(xiii) Benefit to the Economy:
FIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring

funds from surplus to deficit units, FIs create large financial assets and liabilities. They provide the economy with money supply and with near money assets.

Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country. In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the FIs.

2. Role of Financial Intermediaries in Economic Growth:
Financial intermediaries which consist of commercial banks, cooperative credit societies, mutual savings funds, mutual funds, saving and loan associations, insurance companies, and other financial institutions, help in the growth process of the economy. They intermediate between ultimate lenders who are savers and ultimate borrowers who are investors. By performing this function they discourage hoarding by the people, mobilise their savings and lend them to investors.

Investors can borrow funds internally by using their own savings or/and externally by using the savings of others. FIs provide external finance. Savers who are ultimate lenders deposit their savings with FIs, and FIs, in turn, lend these funds to ultimate borrowers. The difference between lending and borrowing rates are the profits of FIs. FIs lend to borrowers by purchasing primary securities issued by the latter. These are bonds, equities, mortgages, bills, etc. FIs buy them with the funds kept by the savers with them.

They are, therefore, able to profit by this transformation process by exploiting the economies of scale in lending and borrowing. On the lending side, the intermediaries can invest and manage investments in primary securities at unit cost far below the experience of most individual lenders. The large size of their portfolios permits a significant reduction in risks through diversification.

They can schedule maturities of primary securities in such a manner that chances of liquidity crises are minimised. They are favoured with tax benefits that are not available to individual savers. On the borrowing side, with a large number of depositors they can normally rely on a predictable schedule of claims for repayment. Thus FIs encourage saving and investment which are essential for promoting economic growth.

Savings are essential for capital formation without which economic growth is not possible. Mere savings are not enough for capital formation. They are required to be mobilised which is done by FIs. Even mobilisation of savings does not lead to capital formation. They must be channelised into productive investments. By lending to ultimate borrowers, FIs promote investment.

Thus the role of FIs in the growth process is partly that of buying securities of one kind from borrowers and selling securities of another kind to lenders, and thereby contributes to an increase in the willingness to save and the inducement to invest. More importantly they try to find out better investment opportunities and facilitate their exploitation by helping industry.

Among other factors, investment depends upon the rate of interest. The lower the interest rate, the higher is the investment. Competition among FIs for primary securities raises their prices and lowers the interest rate. Moreover, when savers keep their cash holdings with FIs which involve less risk, and are safe and liquid, the demand for money falls which further lowers the interest rate.

The fall in interest rate encourages investment which increase the rate of capital formation and hence promotes economic growth. Goldsmith's study has shown that the growth of FIs has been responsible for the economic growth of developed countries in a significant way.

3. Role of Financial Intermediaries in Underdeveloped Countries:

Financial intermediaries play a special role in under-developed countries. In such countries the capital market is unorganised and undeveloped. The majority of the people are poor and they cannot save. Those who save, invest their savings in gold, jewellery, real estate, speculation, foreign exchange, and conspicuous consumption.

Under these circumstances, FIs undertake the task of encouraging the flow of personal savings from unproductive to productive uses. They encourage households to hold financial assets instead of physical assets. To the extent households are willing to switch from the purchase of physical assets to financial assets to serve as their instruments of saving, resources are released for development purposes.

Further, as the economy develops, the non-monetized sector is gradually transformed into the monetized sector. With the increase in the rate of monetization of the economy, the banking habits of the people also grow. In such a situation, the commercial banks alone are not sufficient to mobilise savings and put them into productive channels. So the role of FIs becomes all the more important in mobilising and investing these savings for capital formation and economic development.

In UDCs, there is the absence of an environment for entrepreneurship because of the lack of effective lending institutions. FIs help small firms to a greater degree than the large firms. They find investment opportunities and facilitate their exploitation by helping small, and new enterprises in UDCs.

The growth of FIs in the course of development in such countries helps in economising the use of money. As these financial institutions grow, they sell indirect securities to savers. These securities are close substitutes for money. So the savers buy securities instead of keeping money in cash.

It is in this way that these financial intermediaries help in economising the use of money which, in turn, controls the money supply and the demand for goods and services from increasing. Thus FIs help in controlling inflation indirectly in underdeveloped countries.

4. Role of Financial Intermediaries in the Saving-Investment Process:

Financial intermediaries transmute funds between savers who lend and investors who borrow. They mobilise savings and channel them into the hands of investors who need more funds than

they have on hand. In other words, they are conduits through which savers can lend their excess funds to investors.

FIs are commercial banks, cooperative societies and banks, mutual savings banks, mutual funds, savings and loan associations, insurance companies, merchant banks, unit trusts, and other types of financial institutions. They act as middlemen by transferring funds from savers to investors.

By lending their surplus funds, savers stand to gain because they earn interest or dividend on their funds. On the other hand, investors stand to benefit when they borrow to carry out their investment plans. Without financial intermediaries, savers would hoard their surplus funds, and investors (borrowers) would not carry out their investment plans except those who can finance internally.

The essential function of FIs is to satisfy simultaneously the portfolio preference of both savers and investors. Savers are ultimate lenders whose assets are bank deposits, insurance policies, pensions, etc. Investors are ultimate borrowers or non-financial units who wish to expand their holdings of such real assets as inventories, real estate, plant and equipment, etc. They finance these by issuing primary securities which are bonds, corporate equities, debts of individuals and businesses, mortgages, bills, etc. These are their liabilities.

FIs issue indirect or secondary securities. They are currency, demand and time deposits of commercial banks, and saving deposits, insurance and pension funds of nonfinancial intermediaries. FIs intermediate between original savers and ultimate borrowers or investors.

Savers deposit funds with FIs instead of directly purchasing bonds, mortgages or equities, and FIs, in turn, lend funds to ultimate borrowers. FIs acquire primary securities issued by ultimate borrowers, and in turn, issue their own secondary securities for the portfolio of ultimate lenders (savers).

In other words, investors sell securities to banks and receive newly created demand deposits in return in banks. These deposits are then spent on current output and ultimately accrue to the savers in the community as financial assets. Investors also sell securities to non-bank financial intermediaries. These, in turn, sell claim on themselves to the savers.

Thus the non-bank financial intermediaries are able to supply debt instruments particularly suitable to the needs of the borrowers independent of the type of assets that the lenders want. Similarly, they offer financial assets to the lenders independent of the type of debt instrument the borrowers are prepared to issue.

Besides bringing savers and lenders together, FIs transmute the primary securities issued by the nonfinancial units (borrowers) into secondary securities (issued by FIs themselves) possessing greater liquidity, convenience, lower risk, etc. in order to attract wealth holders (savers). Thus FIs turn primary securities into secondary securities for the portfolio of ultimate lenders.

They give lenders a wide variety of financial assets particularly suited to their needs. They also make it less necessary for borrowers to issue those types of securities which are ill-adapted to

their own businesses. Thus FIs by liquifying and diversifying the securities issued by the lenders encourage saving or discourage dissaving.

Further, the techniques of intermediation get primary securities distributed efficiently from ultimate borrowers to ultimate lenders and from one lender to another through dealers and security exchanges. They tend to raise the level of saving and investment by increasing the marginal utility of last dealer's worth of financial assets to the lender and reducing the marginal disutility of the last dealer's worth of debt to the borrower.

They also tend to increase the efficiency of resource allocation by placing more investment projects against one another for lenders to examine. Thus FIs are able to improve the efficiency of distributive techniques of intermediation in many ways. Their role in the saving-investment process is quite similar to that of distributive techniques, lotteries or land sales. They enable investors to spend more efficiently.

Source: https://www.microeconomicsnotes.com/

Role of Non-Bank Financial Intermediaries (NBFIs).
The following points highlight the top seventeen roles of Non-Bank Financial Intermediaries (NBFIs). Some of the roles are: 1. Reduce Hoarding 2. Help the Household Sector 3. Help the Business Sector 4. Help the State and Local Government 5. Help the Central Government 6. Lenders and NBFIs both Earn 7. Provide Liquidity 8. Help in Lowering Interest Rate and Others.

Role # 1. Reduce Hoarding:
By bringing the ultimate lenders (or savers) and ultimate borrowers together, NBFIs reduce hoarding of cash by the people under the "mattress", as is commonly said.

Role # 2. Help the Household Sector:
The household sector relies on NBFIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans, etc. Thus they promote saving and investment habits among the ordinary people.

Role # 3. Help the Business Sector:
NBFIs also help the nonfinancial business sector by financing it through loans, mortgages, purchase of bonds, shares, etc. Thus they facilitate investment in plant, equipment and inventories.

Role # 4. Help the State and Local Government:
NBFIs help the state and local bodies financially by purchasing their bonds.

Role # 5. Help the Central Government:
Similarly, they buy and sell central government securities and thus they help the central government.

Role # 6. Lenders and NBFIs both Earn:
When savers deposit their funds with NBFIs, they earn interest. When NBFIs lend to ultimate borrowers, they earn profits. In fact, the reward of intermediation arises from the difference between the rate of return on primary securities held by NBFIs and the interest or dividend rate they pay on their indirect debt.

Role # 7. Provide Liquidity:
NBFIs provide liquidity when they convert an asset into cash easily and quickly without loss of value in terms of money. When NBFIs issue claims against themselves and supply funds they, especially banks, always try to maintain their liquidity. This they do by following two rules: first, they make short-term loans and finance them by issuing claims against themselves for longer periods; and second, they diversify loans among different types of borrowers.

Role # 8. Help in Lowering Interest Rate:
Competition among NBFIs leads to the lowering of interest rates. NBFIs prefer to keep their saving with NBFIs rather than in cash. The NBFIs, in turn, invest them in primary securities. Consequently, prices of securities are bid up and interest rates fall. Moreover, when people keep their cash holdings with NBFIs which are safe and liquid, the demand for money falls thereby lowering interest rates.

Role # 9. Low Interest Rates Benefit both Savers and Investors:
When interest rates decline, both savers and investors benefit. First, the real costs of lending to borrowers are reduced. These, in turn, tend to reduce costs and prices of goods and services. With reduction in interest rates, the return on time deposits is also' reduced which induces savers to deposit their funds with NBFIs even though the latter pay lower interest rates.

Still the savers benefit because NBFIs provide greater safety, convenience and other related services to them thereby increasing the savers' real return and income.

Role # 10. Brokers of Loanable Funds:
NBFIs play an important role as brokers of loanable funds. They act as intermediaries between the ultimate saver and the ultimate investor. They sell indirect securities to savers and purchase primary securities from investors. Indirect securities are the short-term liabilities of financial intermediaries.

On the other hand, primary securities are their earning assets but they are the debts of the borrowers. Thus NBFIs act as brokers of loanable funds by changing debt into credit.

Role # 11. Reduce Risks:
When the non-bank financial intermediaries convert debt into credit, they reduce the risk to the ultimate lender. First, they create liabilities on themselves by selling indirect securities to the lenders. Then they buy primary securities from borrowers of funds.

So by acting as intermediaries between the lenders and borrowers of funds, NBFIs take the risk on themselves and reduce it on the ultimate lenders. Moreover, by holding varied types of financial assets, they decrease their own risks. Low returns on some assets can be offset by high returns on others.

Mobilising Savings. NBFIs raise funds in the capital market and supply credit to investors. Expert financial services provided by them have been attracting larger share of public savings. Such services include easy liquidity, safety of principal, and ready divisibility of savings into direct securities of different values.

They have been able to mobilise more funds due to the development of two types of non-bank financial intermediaries. The first are the depository intermediaries which include savings and loan associations, credit unions, and mutual savings banks.

There is high liquidity of savings in such institutions which attract small savers. Moreover, they issue fixed price assets whose value does not change like the market price of other types of assets. The second are the contractual intermediaries which enter into contract with savers and provide them various types of benefits over the long run. Such institutions are pension funds, life insurance companies and public provident funds. These two types of financial intermediaries in particular help in mobilising public savings.

Role # 12. Investment of Funds:

NBFIs exist because they want to earn profit by investing the mobilised savings. Different financial intermediaries follow different investment policies. For instance, savings and loan associations and mutual savings banks invest in mortgages, and insurance companies invest in bonds and securities. Thus intermediaries mobilise public savings, invest them and thereby help in capital formation and economic growth.

Role # 13. Create New Assets and Liabilities:

Gardner Ackley has shown that in intermediating between ultimate lenders and direct investors, NBFIs add greatly to the stock of financial assets available to savers and for every extra asset, they also create an equal new financial liability. But intermediation does not affect total net worth. He concludes that although intermediation does not increase total wealth or income, it can be assumed that it increases welfare.

Role # 14. Economies of Scale:

NBFIs reap a number of economies of specialisation and scale in mobilising savings and making investments. It would be costly and cumbersome for individual savers to lend their funds to individual borrowers. NBFIs make larger transactions with ultimate lenders and borrowers.

They specialise in trading large financial assets and thus have lower costs in buying and selling securities. They employ expert Staff and efficient machinery and equipment, thereby increasing productivity in the transfer of funds.

Role # 15. Bring Stability in the Capital Market:

NBFIs deal in a variety of assets and liabilities which are mostly traded in the capital market. If there were no NBFIs, there would be frequent changes in the demand and supply of financial assets and their relative yields, thereby bringing instability in the capital market. As NBFIs function within a legal framework and set rules, they provide stability to the capital market and benefit savers and firms through diversified financial services.

Role # 16. Benefit to the Economy:

NBFIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy. By transferring funds from surplus to deficit units. NBFIs create large financial assets and liabilities.

They provide the economy with money supply and with near money assets. Thus they help in the working of financial markets. Since the financial markets govern the working of the economy, the monetary and credit policies of the central bank are changed in such a manner from time to time that the financial markets function smoothly in the country.

In fact, the growth of the economy is dependent upon the proper functioning of the financial system which, in turn, depends to a large extent upon the NBFIs.

Role # 17. Help in the Growth Process of Economy:

NBFIs help in the growth process of the economy. They intermediate between ultimate lenders who are savers and ultimate borrowers who are investors. By performing this function, they discourage hoarding by the people, mobilise their savings and lend them to investors.

Thus NBFIs encourage saving and investment which are essential for promoting economic growth. Goldsmith’s study has shown that the growth of NBFIs has been responsible for the economic growth of developed countries in a significant way.

We may conclude that NBFIs provide liquidity and safety to financial assets and help in transferring funds from ultimate lenders to ultimate borrowers for productive purposes. They increase capital formation and consequently lead to economic growth.

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