

Financial Institutions and Economic Policy: A Review

P. P. Timilsina*

Introduction

In a paper dealing with financial institutions a definition of the subject matter and an explanation of why they are important may seem unnecessary, because in every modern society they are so intermingled with man that without them the economic activities of human being can not be promoted. However, with an aim to delimit myself to the area needed for this discussion, at first, it has been tried to present the background of the less developed countries where the financial institutions have to work to meet the requirement of the economic policy, secondly, the structure of various national and international financial institutions responsible for economic development has been dealt, thirdly, the controversy existing in the pattern of economic policy has been touched upon and finally, the interrelationship between financial institutions and economic policy has been analysed.

(a) *Financial Institutions* : In any economy the process of saving and investment is the most important element to make the economy more dynamic. The relationship between the two are crucial whether we are concerned with business fluctuations, and the level of economic activity in a developed economy or the process of economic growth in a less developed economy. As the economy goes on developing the saving and investment activities are un-

* Dr. Timilsina, formerly Dean of the Institute of Humanities and Social Sciences, is Professor of Economics at Tribhuvan University, Kirtipur, Nepal.

undertaken separately by different individuals and business firms. The process is more facilitated by a variety of financial institutions and financial instruments interacting in a complex set of financial systems. However, saving and investment go on in all economies, irrespective of their level of development.

In a primitive economy also saving and investment take place, however in such an economy both these elements act as one, where the producer himself act as saver and investor. The more complex the economy becomes the possibilities of borrowing and lending expand the opportunities for both saving and investment. A farmer seeking to expand his production can borrow seed from someone who has a surplus with his investment. Here even the interest becomes the part of this transaction, for it is assumed that the borrower can pay more than what he has borrowed because the investment process is productive one. Here the process of saving and investment takes place without any financial institution or financial instruments. But in this case the shift of resources from a surplus unit to a deficit unit took place. The more the economy will advance, the role of shifting resources from the surplus unit to the deficit unit will be played by financial institutions.

More complex and sophisticated financial system extends the alternatives available to both the suppliers and demanders of funds. When more and more modern sector will develop in an economy, more and more sophisticated financial system will be its essential feature. The mass production and distribution of goods and services and the high degree of specialization involved are mirrored in the financial sector of the economy by a similar degree of complex interaction. In such a situation the saving-investment process is facilitated by numerous institutions that offer savers a wide variety of substitutes for real goods or money, thus encouraging the flow and diversification of saving, and many methods of providing borrowers with funds to meet their requirements, thus promoting investment spending. So for us the financial institutions are those organisations which help directly or indirectly in mobilising the resources from the surplus sector or units to the deficit sector or units.

(b) *The Economic Policy*: It is the convention with the economists that at the core of all their study there is one key problem : scarce resources in relation

to the demand made upon them. So choices are necessary. "The task for economic decision makers (assuming they are rational) is to do the best they can to maximize some value or other or several values simultaneously--under the constraint of scarcity. Policy is viewed as a problem of maximization under constraint and attention is concentrated on three sets of interrelated variables: (i) Independent variables, which are the instruments available to decision makers, (ii) dependent variables, which are the targets of decision makers, (iii) parameters, which are the constraints on decision makers".¹

In analysing certain economic issues models are formed showing the relationship between dependent and independent variables and the nature of each functional relationship is assumed to be determined by the parametric constraints. Hence an economist trying to settle a course with regard to certain economic problem, the specific model enables him to analyse how the existing instruments may be used to maximise a certain target remaining within the constraints imposed by objective circumstances. As soon as multiple targets are incorporated the problem becomes complicated, where the trade-offs at the margin among several targets are to be established which ultimately leads to joint maximization of values.

Economic theory while talking on production tries to maximise the target of profit by using various instruments--price and quantity of output, subject to such constraints--inputs, demand for output and the prices of related goods. Economic theory, when referred to analyse the individual consumer, it endeavours to maximise the target of personal utility by varying purchases, subject to constraints of income and taste. In this sort of issues relating to one unit, whether that of production or that of consumption, there is a single dependent variable and such relationship can be very easily quantified. However, when economic theory comes to explain the behaviour of the public or governmental economic units economic analysis becomes very complex because the economic policy makers will have multiple policy targets. In this situation, in addition to the economic variables, political, social and cultural variables also enter into it and the problem becomes very complex, where the policy makers will have to find out trade-offs among all the targets. When we make

¹ Benjamin J. Cohen, *Organising the World's Money* (New York : Basic Books, Inc. Publishers, 1977), p. 42.

from domestic economic policy making to external economic policy, the problem becomes further complex.

Thus in our subject matter, we have two important elements: (i) financial institutions, which help to channelize the resources from the surplus to deficit sector and (ii) the economic policy, which intends to maximize values. In a given parametric constraint economic target of a nation is dependent on the capability of the financial institutions to mobilise resources for economic development of less developed countries which are facing several challenges.

The Challenges of Less Developed Countries

Developing Countries: Guinea Pig for Economists :

The approaches adopted by economists for the development of less developed countries from 1950 to the present day remained still on trial. In the 1950's development economist treated capital as the only scarce factor. The developed countries and the multilateral agencies providing aid to the less developed countries also shared this view of development economists. The macro-economic approach adopted by the less developing countries led to adopt planning and policy concerned more with attracting foreign aid and investment and squeezing savings of the nations' population. These resources were heavily invested in infrastructure and industrialization without taking into consideration the development of projects which could stand international competition. The heavy imports of inputs for industries and for the development of infrastructure caused heavy pressure on their foreign exchange reserves, and for servicing cost of debts, and the misfortune of declining commodity prices produced balance of payments crisis, imposition of foreign exchange control, high tariff to protect inefficient infant industries, and inflationary pressures. These difficulties were exacerbated by lagging agricultural sector depressed by low prices for food controlled at low levels.

The industrialisation fetish has developed in the mind of the policy makers of the less developed countries. Consequently in some countries more stress was given on

the development of capital goods producing industries, which virtually led to heavy pressure on the balance of payment position. In addition to it, the import substitution was adopted by the national government, and tried to establish industries in areas which did not have adequate infrastructure, consequently more resource were to be invested in building specific infrastructure. The economists of the developed countries, who were brought up in an era of great economic crisis of 1930's and the world war II period who had the experiences of rationing and control, when turned their attention to the problems of newly emergent nations tried to prescribe the same type of policy of control and building of national industries. All these helped to develop some industries in less developed countries, however, this could not help to narrow down the inequalities in income distribution, for the income of the rural people could not grow as that of the people of urban areas.

Some economists further advocated that capital could be generated by moving the labour from the non-capitalist sector—subsistence agriculture, petty trading and domestic service of the economy, where the labour has zero or close to zero marginal opportunity cost, into industry, without sacrificing output of the non-capitalist sector. However, the movement of labour from agriculture to industry is a costly affair and many social costs are to be incurred in the growth of urban areas around the factories.

Subsequent literature on economic development identified the importance of education and human capital as a key factor in economic growth in U.S.A., West Europe and Japan. "Once again the ideas were transferred uncritically into the context of the developing countries",² many less developed countries in 1960's invested on the developed of education, however, this tendency caused for the outflux of educated people from rural to urban areas. Educated unemployment occurred mostly in urban areas and ultimately the emmigration also took place in many less developed countries. The educated preferred mostly white coloured jobs, which could not be created rapidly to cope with the rising number of educated people.

More recently in 1970's the development economists have concentrated their attention

2 Alasdair I Mac Bean and V. N. Balasubramanyam, *Meeting the Third World Challenge* (New York: St. Martin's Press for Trade Policy Research Centre, London, 1976), P. 234.

on technology as a factor responsible for accelerating rate of economic development. The adoption of new technology has helped in improving the cultivation of rice and wheat in late 60's and 70's. This has also attracted the less developed countries, for adopting more advanced and sophisticated technology, however, due to lack of other infrastructure such as market, skill and management more developed technology became difficult to maintain in less developed countries. So they have been trying to adopt intermediate technology.

The stress on the various elements capital, education skill, technology as factors enhancing economic growth could not virtually improve the living standard of the mass of people living in the less developed countries, though they have brought certain changes in the economy by enhancing the per capita GNP yet because of the existence of inequalities in the distribution of income the higher per capita income is not necessarily higher standard of living of the mass of people. The development economists and the policy makers of the present have a feeling that if the general condition of the mass is not improved and a dualistic situation is created, the less developed countries will have to face various sorts of instability which may even create political disturbances, so they are trying to adopt a basic needs approach in development, endeavouring to provide essential elements such as food, shelter, clothing, health and education. In spite of various efforts of national governments as well as multilateral organisations, less developed countries are facing still various challenges and the efforts so far carried have made the developing countries simply a field for experimenting various approaches, but giving no fruitful results to the masses of poor people of the less developed countries.

The Challenges to the Less Developed Countries in 1980's

The less developed countries are beset with various sorts of problems encompassing all the sectors of the economy. Less developed economies are having the scarcity economy with rising expectations. The people of the developing countries coming into close contact with the developed market economies through direct contact or indirectly through various forms of communication, are also allured by the physical wellbeing however, the income generating capability of such countries is very low. A big gap between the expectations and income in less developed countries have

further created frustration in the less developed economies. This is further manifested in various international forums where the northern and southern nations meet. The less developed southern nations begging for better markets for their products in the markets of the developed economies of the northern nations could not be accepted by the northern nations. The developed nations are more guided by their self interest in providing aid or market facilities.

The less developed countries do not have the same level of development, they are more heterogeneous. There are (i) low income economies with a per capita GNP of less than U. S. Dollars 400 (1981) (ii) lower middle income economies with an average per capita GNP of U. S. Dollar 850 (iii) upper middle income economies with an average per capita GNP of U. S. Dollar 2490 (iv) high income oil exporting economies with an average per capita GNP of U. S. dollar 13,460³. The nature of the problem of each group is quite different making them less cohesive while bargaining with the more developed economies.

The World Development Report 1983, published by the World Bank clearly depicts the position of the less developed economies in the world economy. The economies of less developed countries are so linked with the world economy that any upheaval occurring in the world economy is shared more severely by less developed economies. The recession existing in the world economy from 1980-82 have affected the less developed economies. Protectionist sentiments have been growing in the industrial countries.⁴ Debt servicing has become a problem to those less developed countries who have borrowed heavily. In this way for the last 'Three years (1980-82) world wide development has been stunted by recession. While population continues to grow inexorably, production and trade have lagged, unemployment has risen, much industrial capacity remained idle and the standard of living in Africa and Latin America has declined'.⁵

3 IBRD, *World Development Report 1983* (New York : Oxford University Press, Published for the World Bank, 1983), pp.168-169

4. *Ibid*, P. 3

5. *Ibid*, P. 125.

In this sort of challenges to the less developed economies, the financial institutions and the economic policy of the government have to play important role in solving both the short term and long term problems.

Structure of Financial Institutions

In a modern economy various financial institutions operate to finance different sectors of an economy. It has been tried to present an overview on the operation of different financial institutions- national and international, which are responsible in financing national economies of the less developed countries directly or indirectly to accelerate the rate of economic growth.

1. The financial System

The financial system of an economy is composed of :

a. The financial Market : It is the market for medium term and long term loans. It serves the needs of industry and commerce, government and local authority. Business firms raise their fixed capital by an issue of shares or from their own reserves, the shares being taken up by individuals, insurance companies, investment trusts. Companies also go to the capital market to borrow by means of debentures, the government or a local authority by the issue of a new stock.

b. The Money Market: It is the market for very short term loans. The commodity exchanged in the money market is investible funds. A money market handles the transactions in short term government obligations, bankers acceptances and commercial papers. Funds are made available for short period investment to the business community who are in need of such funds. Generally the demand for funds in the money market is from the government, business firms, securities brokers and dealers, state and local governments. Supply of funds to the money markets are made mostly by commercial banks. Other organisations like business firms, other financial institutions, central bank also supply fund to money market.

c. *Commercial Banks:* Banks are indispensable organisation of economic progress. The more the economy develops the more the importance of the bank enhances. It provides an opportunity to the savers to invest their saving, and provides the business firms with ample of fund for enhancing production in a nation. The scattered savings of individuals, and business firms are collected in the form of deposits. In the past commercial banks used to finance for short term, however, bank lending operations have changed considerably over the years, the banks have started advancing loans to industrial and agricultural sectors. In addition to deposit services and financing activities, banks provide some additional services to their customers.

d. *Development Banks:* With an aim to provide long term finance to industries, agriculture and other sectors, special financial institutions are being created even in the developed economies, where such institutions concentrate in expanding the existing concerns, whereas, in the less developed countries, where there is not the question of expansion, but there is the question of setting up of industries and transforming agriculture from subsistence household sector to more capitalistic type, the need of such organisations have further been felt. These banks are generally created by the government to meet the requirements of capital in the productive sectors.

e. *Non-Depository Intermediaries:* Unlike the commercial banks, there exist some financial institutions, which do not have highly liquid liabilities, such institutions are retirement fund, the life insurance company and other insurance companies. The liability of retirement fund (provident fund) is delayed till old age, of the life insurance company till death, and of the other insurance companies till catastrophe. Since payments to retired employees are on a definite contractual basis, the retirement funds have little need for liquidity. Generally the assets of such funds are invested in bonds, stocks and mortgages, (in Nepal they also deposit in time deposit). The liquidity needs of life insurance companies are not very great. Although liquidity needs are small, safety is extremely important to a life insurance company, for this reason, most of the assets of life insurance companies are invested in bonds and mortgages.

f. *Cooperative Societies:* In most of the developing countries cooperative credit societies are formed by mobilising voluntarily the resources of the interested groups. These societies are generally formed in the rural areas to provide credit to the agriculturists. In some countries, even the consumer credit societies are formed to provide goods to the consumers at a reasonable price.

g. *Central Bank:* The Central Bank of a country has virtually two types of role. At first, it has to function as a financial institution activating other financial institutions to channelise their investment for accelerating the rate of economic growth. In this regard the central bank provides long term and short term capital to other financial institutions, creates specific infrastructure to channelise the investment of the commercial banks to the desired sector. In addition to it, the central bank in the less developed countries helps to the government to raise capital by purchasing government bonds. Secondly, the central bank has other traditional function of maintaining monetary policy of the government. The central bank, being the regulator of currency, supplies currency in accordance with the requirements of business and the general public, controls credit in accordance with the needs of business, acts as the custody of nation's reserve of foreign currency, acts as the banker to the government and the commercial banks and carries various other functions in maintaining congenial financial atmosphere in the country. (the Monetary Policy will be discussed in detail in the subsequent section). So the central bank is the important monetary institution which manages the monetary system, so as to affect the aggregate level of spending.

2. *International Financing*

In the modern world financing does not stop at national boundaries, but there is no distinct line separating inter and international financing. Activities of multinational corporations are not easily assigned to any one geographical area. "The American role in international finance is unique in the world, because the U. S. Dollar

serves as a type of international money. Dollars are the unit of accounting for many international transactions, and dollars are also the payments media, even for transactions in which the United States is not a direct party. The American dollar became the unchallenged international money following world war II. It was the only currency that governments could hold and convert to gold, but the cessation of gold convertibility in 1971 did not topple the dollar as an international money."

The basic reason for dollar being accepted as a currency for international transaction is attributed to the freedom of access that the United States allows to its financial markets as compared to other countries. In the year 1982, the share of the U. S. Dollar in total identified official holding of foreign exchange was 71 percent. In the international financing, the Eurodollars and Eurocurrency and the petrodollars have played a significant role. In addition to it, there are various international financial institutions which are involved in meeting the requirement of international transactions.

a. *International Monetary Fund*: International Monetary Fund (IMF) is a multilateral organisation established after world war II to foster international economic relations and currency stability. In addition, it is also a facility by which member countries may obtain funds for defense of their exchange rates. Each country has a quota with the fund, which in an advance commitment to lend its currency up to a limit. Countries whose currencies are strong become lenders to those whose currencies are weak. Borrowing of a certain amount based in a country's quota is almost automatically available, and thus countries count as part of their reserves their "IMF positions". In 1969, 'Special Drawing Right' involving 16 of the members countries as unit of account, the SDR was created with specified proportions of each of the countries currencies in it. Participating countries are allocated SDR which can be used to purchase foreign exchange from other participating coun-

© Paul M. Horvitz and Richard A ward, *Monetary Policy and the Financial System*, Fifth Edition (New Jersey: Prentice Hall Inc. 1983), p. 209.

7 *Annual Report 1983 of International Monetary Fund* Washington DC, 1983, p. 70.

tries, tapping those whose reserve positions are strongest. The basis for valuation of the SDR is the weighted average of exchange rates of five major currencies. The SDR system has so far played a rather limited role in the international monetary system, and its structure is subject to further change. (Value of SDR computed by IMF on June 30, 1983 was \$ 1.06835 per SDR)

b. The World Bank Group: The three other international organisations, which are often referred to collectively as the World Bank Group, are established with an aim to develop a strong system of international trade by promoting economic development and growth in many of the underdeveloped countries of the world.

The first is the International Bank for Reconstruction and Development (IBRD), which was created along with the IMF. The Bank and IMF are separate organisations but they are closely related. The IMF engages in short and intermediate transactions, whereas the IBRD makes long term loans. IBRD makes loans on specific projects that are expected to pay for themselves, and the borrowing countries must repay in hard currencies. The Bank may fund directly, guarantee loans made to by other to government or private enterprises of the member countries. It generally finances for public utilities, and does not finance sectors of social character. The Bank charges all borrowers the same rate a rate high enough apparently, to cover fully the bank's cost. The Bank has three sources for its capital—20 per cent of the subscription quotas, the Bank's borrowing in the international capital market and net earnings. The International Finance Corporation (IFC) which is associated with IBRD, was established in 1956. It makes investment including certain types of equity claims, to private business firms in underdeveloped countries. The loans of the IFC do not require guarantees from the government of the country in which the investment will be made. Rates and means of repayment are subject to negotiation. The International Development Association (IDA) was established in 1959 to grant loans to underdeveloped countries, on easier terms than those of IBRD. Loans made by IDA carry low interest rates and long maturities and may be repaid in local currency.

c. *Other Institutions:* various regional international financial institutions have been established to assist the less developed countries.

- (i) *Inter-American Development Bank (IDB)* was established in 1959 to assist the development of Latin American Countries. Its lending terms are softer than that of IBRD.
- (ii) *The Asian Development Bank (ADB)* was established in 1966 to foster economic development in Asia. Although in the beginning United States played a major role in the creation of ADB, today Japan is the largest contributor to the bank. ADB has tended to have a more conservative lending policy than the other international financial institutions.
- (iii) *The African Development Fund (AFDF)* established in 1973, provides soft loans to African nations.
- (iv) *Bank of International Settlement (BIS)* is based in Basel Switzerland, is a sort of central bank for central banks. It has been involved in arranging currency swaps. The monthly meeting of central bankers of the leading countries of the world have been the occasion for discussions and bilateral and multilateral arrangements designed to support the international financial system.

Features of Economic Policy

As mentioned above, economic policy aims to maximise the value with a judicious utilisation of scarce resources. The principal aims of economic policy are:

- (i) to maintain full employment
- (ii) to maintain as high a rate of economic growth as possible, so as to raise the level of living of the people.
- (iii) to increase economic welfare by redistributing the wealth and income, and
- (iv) to maintain stability of the monetary unit i. e. to keep inflation in check.

As economic is also concerned with man, an economic policy of a nation aims to bri-

ng human improvement. Economic Policy is often very closely related to social policy, which considers the social security and improvement of the living condition.

1. Development of Economic policy

A controversy regarding the approach of economic policy has been developed just before the development of the science of Economics in 1776 by Adam Smith. Prior to him the mercantilists held a view that controlled foreign trade with the formation of monopolies, will foster economic development. However, Adam Smith and his forerunners the French Physiocrats, viewed that free trade or laissez faire policy is the precondition for bringing harmonic economic relation in the society there by causing full utilisation of resources. This prevailed for a long time as classical approach. The role of the state was limited to the field of maintaining law and order and maintainance of public utilities. However, the German nationalists in the nineteenth century viewed that free trade policy would not promote the development of Germany, so they advocated for the intervention of the state, to protect the German industries. Later on, Marx, desecring the capitalist mode of production, "denies for the final state, the pillars of the market economy.....taking as his starting point a society without private ownership of the means of production and the collective control of the economy he lays the foundation for the controlled economy"⁸ This has become the core of the economic policy of the socialist countries. Not until the world Depression between the two world wars does economic policy detach itself from the classicists faith in self-regulating market economy. In 1933 the United States created a system of control measures for the economy, which takes place in economic history as the "New Deal", for this sort of governmental intervention in an economy, Keynes creates a new theoretical framework in his book **General Theory of Employment Interest and Money** in 1936.

After the world war II the economic policy has been much directed towards the policy of economic growth, which makes a growing economy the subject of its analysis.

⁸ Reinhard Blum, 'The Interrelationships between Economic Policy and Economic Theory', *The German Economic Review*, Vol. 8, No. 1, 1970 p. 18.

2. Elements of Economic Policy

The goals of economic policy demand for various sorts of actions from the side of the government, so both the macro and sectoral level policies are framed. Of them basically the monetary and fiscal policies are more important.

a. Monetary Policy: Money is itself an important subject for it will have significant effect on the economy. We measure many economic variables in terms of a currency amount income, wages, production and so on. Once we accept the view that money can affect the economy, we are attracted to the possibility of influencing the economy by means of monetary policy. But economists differ greatly about the mechanism by which money affects the economy, the extent of such effects, and the time within which they operate. Instead of indulging on the cause and effect relationship between money and the national economy by explaining various theories developed so far, it is for us appropriate to analyse the monetary policy. The aims of the monetary policy of a government can be classified as: (i) Stabilization (ii) Full employment, and (iii) Economic growth. Many specific actions of government overlap in their goals, and there may be many sub-goals within these classification.

Stability in the price level is the only goal that many economists and policy makers level is the only goal that many economists and policy makers advocate, for they feel that inflationary and deflationary situation negatively affect the goals of economic policy.

Some other adhere to full employment as the economic goal of national economy. These policy makers are concerned about unemployment because it will have negative effect on the goal of distributional equity, and in the aggregate unemployment is a waste of productive resources and means that the goal of maximum economic growth is not being achieved.

Some economists, with an objective to provide maximum welfare advocate that the employment alone may not be effective if the economy is not growing. With the growth they mean (i) increase in physical output, (ii) goods produced should satisfy consumers' wants, (iii) Growth should be achieved within the framework of reasonable degree of econo-

mic freedom. So far achieving economic growth in a market oriented economy the productive capacity should increase with a corresponding increase in the demand for the increase goods and services. The monetary policy might contribute to economic growth in two ways: (i) balancing the total money demand with the production capacity and (ii) by helping to create favourable environment for saving and investment.

In these objectives also we find various sorts of conflicts. The goals of increasing rate of growth and controlling inflation conflicts. Similarly, it is difficult to achieve higher rate of growth when we consider more employment. So the policy makers have to be very cautious in adopting policy measures.

b. Fiscal Policy: Some other economists believe that monetary policy alone is not in a position to achieve the desired economic goals in an economy, when the government's earnings and spendings constitute a large portion of the resources. In addition to it, the governments of many nations are also participating in various developmental activities of an economy, their spendings are directly affecting on the level of employment and income. The revenue raised by the government through taxes takes away the purchasing power from the public, and the spendings of the government enhances the purchasing capacity with the flow of funds in the economy.

Monetary and fiscal policies are complementary to each other. Monetary policy affect the income and expenditure, particularly in the private sector, through the supply of money and the cost of borrowing it, and the fiscal policy affect income and expenditure through the amount, character and timing of government expenditures and revenues.

In fact both the policies take into consideration the flow of funds into the economy and out of the economy, whether they are activated by the monetary or fiscal authorities. In modern economies the financial institutions act as intermediaries between the monetary and fiscal authorities and different economic variables employment, income production and so on.

Financial Institutions and Economic Policy: Their Interrelationship

Financial Institutions act as financial intermediaries between the savings and the goals of an economy. In less developed countries the surplus of a unit is financed to deficit unit directly without financial intermediaries. However, as the economy goes on developing with the development of various industries the financial institution will play dominant role in transferring the resources from the surplus sector or unit to the deficit sector or unit. When the economy is in the process of economic growth, this process of intermediation is further essential for :

- i. The small savers in less developed countries may not be in a position to identify proper market for the investment of fund.
- ii. The securities issued by the financial institution or the deposits of the commercial banks tend to have less risk than primary securities.
- iii. The financial institutions can invest in wide range of different primary securities, which will diversify risk.
- iv. The financial institutions can develop expertise in investment, for they can properly assess the credit worthiness of borrowers.
- v. The assets kept with financial institutions are more liquid than primary securities.
- vi. The savers get better benefits from the investment in financial institutions than from the investment in primary securities, for they will have lesser irritation.
- vii. The borrowers also gain from financial institutions for the latter can supply ample of fund by selling their primary securities.
- viii. The borrowers, showing their creditworthiness will be in a position to borrow from the financial institutions.

In this way it is seen that financial institutions do have very close relation with the economy and it exerts lot of influence in the national economy.

The working of the financial institutions at the same time is dependent on the economic policy. If the monetary and fiscal authorities do not create a congenial atmosphere for enhancing investment, the financial institution can not function.

If the goal of economic policy is directed towards achieving higher rate of economic growth by developing agriculture and industry, the economy needs more investment in these sectors and if financial institutions hesitate to invest in agriculture and industry, then the desired rate of growth may not be achieved. In this situation the monetary authority and the government should provide subsidies or insure the investment so that the financial institutions can also share the responsibility of accelerating growth.

The tight money policy and surplus budget of the government will curtail the activities of the financial institutions and they may not be in a position to expand. Conversely, deficit budgeting reinforced by cheap money policy will promote the investment of the financial institutions. In this way, the economic policy of a nation influences the activities of the financial institutions.

Similarly, the financial institutions acting as intermediaries can exert influence in an economy. As they are the agents supplying funds to the economy, they help to add to the stock of money by supplying additional credit to the economy this may lead to an inflationary situation in the economy, leading to higher price rise and changing the output of goods and services in the short run.

So, in the coming years when the volume of transactions through financial intermediaries will grow in the less developed countries, the economic policy should not concentrate on the shorter term problem of economic stabilization. Inflation has undermined the public's confidence in financial saving, and there is the possibility that this could threaten the saving—investment flows so important to the developing economies. The monetary policy should be discretionary while considering the implementation and incidence of such policy.

While implementing monetary policy certain time lag will be there between the initiation and implementation of the policy, because in less developed countries, there will generally be lags in collection of data and uncertainties in their interpretation. Coming to the incidence, the policy makers should pay more attention to the goals than to the game. The aim of the monetary policy in less developed countries should be to develop properly the financial intermediaries without shaking the confidence of the savers,

so that more investment could be channelised to the desired sector of the economy.

Selected References

- Balassa, Bela (1981)** *The Newly Industrializing Countries in the World Economy*, (New York: Pergamon Press Inc.)
- Bergsten, G. Fred (1981)** *The world Economy in 1980's Selected Papers of G. Fred Bergsten* (Toronto : Lexington Books D. C. Heath and Co. Lexington)
- Cleveland, Harlan, (ed.) (1981)** *The Management of Sustainable Growth* (New York : Pergamon Press, Inc.)
- Cohen, Benjamin J. (1977)** *Organising the Worlds Money—the Political Economy of International Monetary Relations* (New York : Basic books, Inc. Publishers)
- Horvitz, P. M.; Ward, R. A. (1983)** *Monetary Policy and Financial System* (fifth edition), (New Jersey : Prentice Hall Inc.)
- Mac Bean, A. I.; Balasubramanyan, V. N. (1976)** *Meeting the Third World Challenge* (New York : St. Martins Press)
- Reubens P. E. (ed.) (1981)** *The Challenge of the New International Order* (Colorado : Westview Press Inc.)
- IMF (1983)**, *Annual Report* (Washington, D. C.)
- World Bank (1983)**, *Annual Reports* (Washington, D. C.)
- World Bank (1983)** *World Development Reports* (Washington, D. C.)