Financial Segmentation: A Constraint to Growth

Pronab Sen
Country Director, India Central
International Growth Centre

The Issue

- Savings-Investment balance central to all macroeconomics
- This balance is driven by the operation of the financial sector
- Most macro theories treat the financial sector as monolithic, contrary to reality
- Does segmentation of the financial sector matter as far as macroeconomics is concerned?

The Issue … contd.

- Continuing debate between Classical and Keynesian adjustment in developed market economies
- Capital-constrained developing countries assumed to exhibit classical adjustment in most cases (including India)
- Can Keynesian adjustment occur even with price-clearing and/or binding savings constraint?

The Setting

- A developing economy where *ex-ante* investment demand is assumed to exceed *ex-ante* savings
- Closed capital account
- Financial sector consisting of : (a) Commercial banks; (b) Long-term bond market; (c) Equity market
- Asymmetrical information problems assumed away

Proposition 1

- If the distribution of *ex-ante* savings between bank deposits, bonds and equity is different from the distribution of *ex-ante* investment demand between working capital, term debt and equity, the possibility exists that *ex-post* investment will be **lower** than *ex-ante savings*

Proposition 2

- Even if each segment of the financial sector is efficient and clears through price adjustment, *ex-post* investment will be determined by the form of savings which faces the highest level excess demand *ex-ante*

Proposition 3

- Greater the mobility of funds between the different financial instruments through intra-sectoral arrangements, the closer will *ex-post* investment be to *ex-ante* savings

Proposition 4

- If the financial sector is unable to move funds efficiently ***between*** instruments, Keynesian adjustment will occur to bring about macroeconomic equilibrium, regardless of the efficiency of each individual segment of the financial sector

Proposition 5

- If the price adjustment process does lead to full absorption of *ex-ante* savings through readjustments in the ***pattern*** of investment demand, then the *ex-post* investment pattern will either:
  (a) Be significantly different from the *ex-ante* investment plan; or
  (b) Lead to an aggregate economy-wide asset-liability mismatch

Proposition 6

(A) If Proposition 5(a) obtains, the *ex-post* investment pattern will be sub-optimal. Growth will be lower than otherwise.

(B) If Proposition 5(b) obtains, economy will face a higher degree of systemic risk. Failure rates will tend to be higher leading to lower effective aggregate investment.

The Keynesian Cure

- Higher public investment through fiscal deficits will reduce the problem, but only if the deficit financing is carried out by tapping that form of savings which faces lowest *ex-ante* excess demand. Otherwise, ‘crowding out’ will take place

Opening the Capital Account

- The real benefit of opening the capital account is not so much the additional flow of external resources (since this is determined by the current account deficit), but by allowing higher utilisation of *ex-ante* savings

THANK YOU