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8. An Analysis of the Role of Financial Intermediaries in the Economy

Dr. Vimmi Behal

Assistant Professor,
Atal Bihari Vajpayee Hindi Vishwavidyalaya,
Bhopal (M.A).

Abstract:

The significant improvement of financial intermediaries suggests the expansion and development of financial systems, which in turn spurs economic growth. Furthermore, credit screening and assigned monitoring with the best debt contracts and bankruptcy fees aid in lessening the issues associated with informational asymmetries. The implications for policy indicate that financial liberalization promotes economic growth by easing financial constraints and financial repression on financial intermediaries. Redistributing household unit excess resources to other financial units is a function of financial intermediaries, who sit at the core of the financial system. Whereas the Borrowers want a long-term borrowing, the Savers prefer a short-term loan. Due to information asymmetry and market inefficiencies, financial intermediaries have evolved from conventional banking to more complex forms such as investment banks, pension funds, mutual funds, venture capital funds, and hedge funds. The significance of financial intermediaries in the financial market is discussed in this article. An Analysis of Financial Intermediaries' Role in the Economy will be covered in this essay.

Keywords:

Analysis, Financial, Intermediaries, Economy, Development, Short-Term Loan, Capital Funds, Banks.

8.1 Introduction:

Financial intermediaries are crucial to both the global financial system and the emerging markets, especially given the quick development of the global economy. Financial intermediaries are companies that raise savers' idle capital and subsequently lend money to people in need of capital. Commercial banks, investment banks, mutual funds, and pension funds are examples of financial intermediaries. The modern economy's enormous capital needs have not been met by the expanding economy alone, nor by the flaws in the financial system. Financial intermediaries develop become a significant indirect capital conduit for the economy. [1]

A financial system is necessary for a healthy and dynamic economy in order to transfer capital from people with money to those who have viable investment opportunities. We shall examine financial intermediation and its significance in financial markets from a broader perspective in this study.

8.1.1 Types of Financial Intermediaries:

The list of companies that make up the financial intermediaries is quite extensive. People frequently don't even realize that the person they are interacting with is merely supervising the particular transaction. Nevertheless, the financial markets would collapse in the absence of these organizations. The following are important financial intermediaries in an economy:

Banks: Without a doubt, the most common financial intermediaries worldwide are banks. They can take many different forms, including lending, saving, investing, and many more subcategories that meet specific requirements. Connecting lenders and borrowers is the oldest method these organizations function as brokers.

Credit Unions: As was previously noted, credit unions draw both those with and without money. As an illustration, they use the deposits they get from other clients to grant credit terms to individuals. Credit unions are able to provide credit to individuals in need because they have cash available to them, funds that are provided by their members.

Pension Funds: Full-time workers frequently interact with this additional financial middleman. Millions of workers do this to fund their retirement. Its operation is predicated on long-term investing, matching contributions, and a risk factor.

Insurance Companies: Even though there are many distinct kinds of insurance organizations, the majority of them function similarly. Initially, they discover a sizable client base in need of covering. It doesn't matter if it's a health insurance, house, or automobile. All of the money is gathered collected when those clients buy their insurance. The insurance provider will later access that fund anytime someone needs to make a claim and use the insurance business to request a payout. This indicates that the market is not receiving any net inflow of capital.

Stock exchanges: Acquiring business stocks may require a protracted and arduous procedure. The stock exchanges were created to make this simpler. They function as sizable ordering portals for stocks. Stock exchanges are used to purchase genuine stocks from firms once they have been paid for. The consumer then receives the desired assets, and businesses receive funding.

Economies of Scale: Because they may collect deposits from a large number of clients and lend money to various borrowers, financial intermediaries benefit from economies of scale. By doing this, businesses are able to lower the overall operating costs associated with their regular business operations.

Financial organizations rarely have to borrow from people who don't have enough money to loan the required amount since they can easily access significant sums of liquid cash to lend to people who have good credit.

Economies of Scope: A variety of specialist services are frequently provided to clients by intermediaries. This allows them to improve their products in order to meet the needs of all kinds of customers.

For instance, when commercial banks lend money, they can alter the terms of the loans to accommodate both small and large customers. Most debtors are frequently small and medium-sized businesses. Banks can increase their customer base by creating packages that meet their needs. [2]

8.2 Review of Literature:

Every economy in the world has some level of financial intermediation. But as Franklin Allen (2001) noted in his AFA Presidential Address, there's a widespread perception that financial middlemen are inconsequential and should be disregarded. They serve as a veil. They have no bearing on resource allocation or asset values. Allen cited the Journal of Finance's Millennium Issue as an example, which included surveys on corporate finance, asset pricing, and regular finance but omitted a study on financial intermediation. In order to understand savings to the investment process, the operation of capital markets, corporate finance decisions, and consumer portfolio choices, we adopt the stance that one should be aware of financial intermediaries. [3]

Institutions that deal with the trading of financial instruments are known as financial intermediaries. Financial institutions, banks, insurance companies, and finance companies that deal with directing money from the economy's surplus to its deficit sector can be created as these intermediaries. In an effort to support economic growth and, at the same time, ensure long-term financial stability, these intermediaries encourage private investment (Massa, 2011). In reality, because of their roles in risk management, project appraisal, manager supervision, and transaction facilitation, financial intermediaries are seen as engines of economic growth. [4]

The part that financial intermediaries play in economic development is covered in a number of studies. According to Fry's (1995) analysis, financial intermediaries' performance in transferring funds from lenders to borrowers is evaluated based on intermediation costs. The study concludes that poor management, government intervention, high delinquency, and default rates contribute to the inefficiencies of financial intermediaries' operations in many developing nations. Through financial intermediation, financial liberalization and deepening would increase the effectiveness of financial intermediaries and promote economic growth. [5]

8.3 Objectives:

- To Study Role of Financial Intermediaries in the Economy.
- An Analysis of the Role of Financial Intermediaries in the Economy.

8.4 Research Methodology:

This study's overall design was exploratory. The research paper is an endeavor that is founded on secondary data that was obtained from reliable online resources, newspapers, textbooks, journals, and publications. The research design of the study is mostly descriptive in nature.

8.5 Result and Discussion:

8.5.1 Financial Intermediary:

An organization that serves as a go-between for two parties to enable a financial transaction is referred to as a financial intermediary.

Financial intermediaries encompass a range of entities, including mutual funds, commercial banks, investment banks, and pension funds.

Through debt and equity, they redistribute uninvest capital to economically productive sections of the economy.

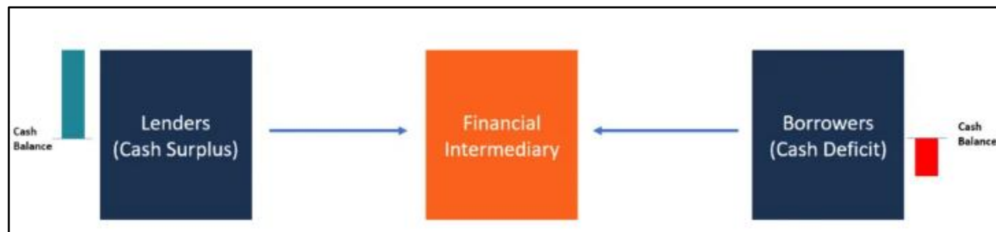

Figure 8.1: Financial Intermediary [6]

8.5.2 Functions of Financial Intermediaries:

The two primary roles of financial intermediaries are the control and capital conduction roles. The two primary avenues via which the financial system is financed are direct financial markets and financial intermediaries.

The purpose of these two systems is to transfer money from people with excess capital to people in need.

The person who needs capital and the person who has it do not have to meet in person when using a financial intermediary, which facilitates speedier capital movement.

When granting loans, financial intermediaries use their supervisory role to lower the danger of moral hazard and adverse selection.

Monetary business sectors allow intermediaries and their clients to sustain risks more effectively than they did in the past by limiting expenses.

Financial intermediaries must thoroughly verify, gather, and process correct information prior to lending, as well as frequently monitor lending and post-lending, in order to effectively carry out this role. [7].

Figure 2 provides a summary of the tasks and responsibilities of financial intermediaries.

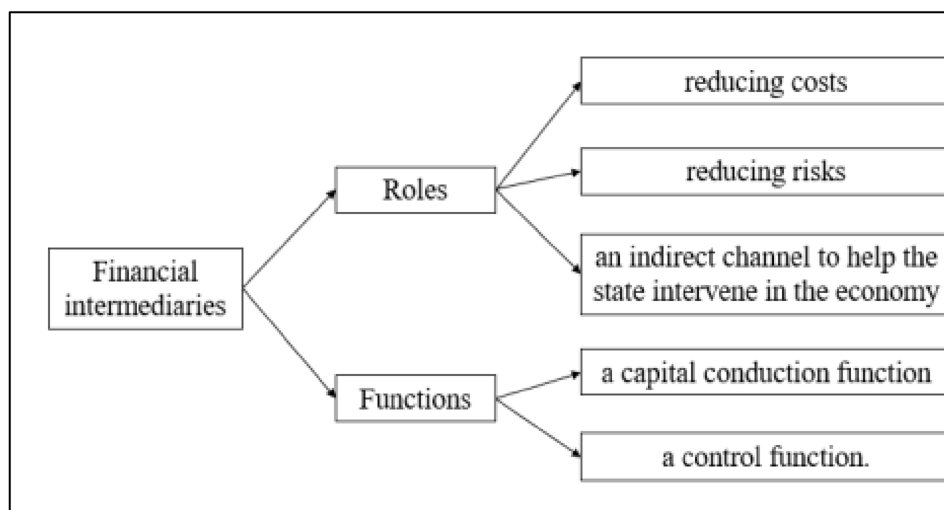

Figure 8.2: Summary of The Roles and Functions of Financial Intermediaries

8.5.3 Financial Intermediaries in the Economy:

Conversely, their economic significance is greater than before and seems to be growing. This was still the case in the 1990s, a time of nearly total market liberalization and a genuine and nearly revolutionary breakthrough in worldwide communication. Tables 1 and 2, which show the financial sector's relative contribution to GDP and labor—the two main indicators of economic income and welfare in the majority of countries—illustrate the trend toward a growing role for financial intermediation. These tables demonstrate how financial intermediaries are becoming more and more important in today's economy, especially in highly developed markets. Moreover, draw the conclusion that, in a significant number of wealthy and poor nations alike, the claims of deposit money banks and other financial institutions on the private sector have risen steadily as a percentage of GDP during the 1960s and 1990s. In the 1990s, the rate of growth is not slowing down. Table 3 demonstrates this.

Table 8.1: Share of Employment in Financial Services in Total Employment (percentages)

	1970	1980	1985	1990	1995	2000
Canada	2.4	2.7	2.9	3.0	3.2	3.1
France	1.8	2.6	2.9	2.8	2.7	2.8
Germany	2.2	2.8	3.0	3.1	3.3	3.3
Japan	2.4	3.0	3.2	3.3	3.4	3.5
Switzerland	-	-	4.6	4.8	4.8	4.9
United Kingdom	-	3.0	3.5	4.6	4.4	4.4
United States	3.8	4.4	4.7	4.8	4.8	4.8
Source: OECD, National Accounts (various issues)						

Table 8.2: Share of Value-Added in Financial Services in GDP (percentages):

	1970	1980	1985	1990	1995	2000
Canada	2.2	1.8	2.0	2.8	2.9	3.1
France	3.5	4.4	4.8	4.4	4.6	4.8
Germany	3.2	4.5	5.5	4.8	5.8	5.7
Japan	4.3	4.5	5.5	4.8	5.6	5.3
Netherlands	3.1	4.0	5.3	5.6	5.5	5.8
Switzerland	-	-	10.4	10.3	13.1	12.8
United States	4.0	4.8	5.5	6.1	7.2	7.1
Source: OECD, National Accounts (various issues)						

Table 8.3: Financial Intermediary Development over Time for About 150 Countries (percentages)

	1960s	1970s	1980s	1990s
Liquid liabilities/GDP	32	39	47	51
Claims by deposit money banks on private sector/GDP	20	24	32	39
Source: Demirgüç-Kunt and Levine (1999, Figure 2A)				

According to the bank-based approach, systems based on banks promote economic growth more than systems based on markets, especially in the early phases of economic development.

- According to the market-based perspective, markets offer essential financial services that foster long-term growth and innovation.
- The financial services perspective emphasizes how markets and banks work together to identify companies, exercise corporate control, develop risk management strategies, and allocate society's money to the most profitable projects. Because of this, it views markets and banks as allies rather than competitors, concentrating instead on the caliber of financial services provided by the financial system as a whole.
- The legal perspective disproves the financial structure debate's analytical viability. It makes the case that the standard of financial services is shaped by the legal system. [8]

8.6 Conclusion:

An important factor in economic development is the function that financial intermediaries play. In the developing world, they are considerably more important, helping the governments combat poverty and create other social programs. Financial intermediaries actively share transaction risks in the financial market, which increases the effectiveness of financial transactions. Financial intermediaries must exist in order for anything to happen. Financial intermediaries serve as a conduit for indirect government economic intervention, helping to lower transaction costs and risks.

The examination of development indices for the financial sector reveals distinct variations between industrialized and developing nations, as well as rising economies. Developed nations have lower stability indices but are superior in terms of financial depth, accessibility to capital, and efficiency. The developed and developing countries are separated by the four emerging country indices.

8.7 References:

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