Chapter 1

Introduction

1.1 Meaning of Finance

The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern. The word "finance" is originally a French word, which implies the management of money. As an academic discipline finance has greater significance and has emerged out as an organized branch of Economics. Finance is concerned with allocation, management, acquisition and investment of resources and is defined as the commercial activities through which banks, financial institutions generate and distribute fund for capital building of industries. It works as a bridge between the fund seekers and fund savers and the success of it helps financial system to perform its functions that lays road to achieve broader national objectives.

According to Oxford dictionary, the word 'finance' connotes 'management of money'. Webster's Ninth New Collegiate Dictionary defines finance as "the Science on study of the management of funds' and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

1.2 Financial System

Funds in bulk amounts lend and borrowed by creditors and debtors respectively, for a particular period of time at a stipulated rate of interest is known as finance. In other words, finance refers to the funds of monetary recourses required by people, business homes and by the Government. Hence all those activities managing finance are organized in a system referred to as the "Financial System or financial Sector". A

financial system includes monetary establishments markets and instruments that along kind the essential framework for mobilization and allocation of savings, the main role of any financial system is to act as passage for the transfer of financial recourses from net savers to borrowers. Financial markets can matter either by affecting the quantity of savings available to finance investment (Bencivenga and smith (1991); or by increasing the productivity of that investment (Greenwood and Jovanovic, 1990; King and Levine 1993). so financial market efficiency can act as a lubricator to the engine of economic process. The financial system is probably the foremost vital institutional and purposeful vehicle for economic transformation. Financial system consists of different types of markets, financial institutions, different- 2 financial instruments, financial services and other mechanisms which influence the creation of savings, investment, capital formation and growth of an economy. The Indian financial system is broadly speaking classified into 2 broad groups: i) organized sector and (ii) Unorganized sector.

The organized financial system is composed of a good network of banks, other financial and investment organizations and variety of financial instruments, that all work together in fairly developed capital and money markets. The various sub-systems of financial system are Banking System, Development banking system, Cooperative system, Money markets and monetary corporations or establishments.

The unorganized financial system is composed of less controlled landlords, moneylenders, indigenous bankers, traders, lending pawn brokers etc. The unorganized financial system part isn't directly amenable to control by the Reserve bank of India (RBI). And unorganized sector is also too big in numbers in India.

1.3 Financial Development

Financial development can be defined as process that marks improvement in quality, quantity, and efficiency of financial intermediary services. It refers to the development and well-being of financial intermediaries and financial markets. Financial Development Report published by World Economic Forum defined financial development as the factors, Policies and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services. Financial development happens when financial instruments, markets and intermediaries ameliorate though doesn't necessarily eliminate –the effects of data, social control and transactions price and thus do a correspondingly higher job at providing the 5 monetary functions. Financial development involves improvement within the production of ex-ante info regarding attainable investments, watching of investment and implementation of corporate governance, trading diversification and management of risk, mobilization & pooling of savings and exchange of goods and services. According to Dorrucci and Drutti (2007), Financial development means the potential of an economy to channel its economy's savings into its investments effectively and efficiently among its own boundaries owing to the quality of its regulatory and institutional framework, the market capitalization of its financial markets, the diversification of its financial instruments and agent's easy access to them and finally the financial market's performance in terms of efficiency, liquidity. Hartmann and Heider (2007) defined financial development as the process of financial innovation also as organizational and institutional enhancements in a financial system, which can minimize asymmetric info, lead to completeness of markets, and add potentialities for agents to have interaction in financial transactions through contracts, scale back dealing prices and increase competition. The scope of

financial development thus includes innovations or improvments in products, establishments and organizations within the banking sector, non-banking financial structures and capital markets.

1.4 Foreign Trade

Foreign trade is the trade between the different countries of the world. It is also called as International trade, External trade or Inter-Regional trade. It consists of imports, exports and “entrepot”. Foreign trade basically takes place for mutual satisfaction of wants and utilities of resources. At the level of Central Government it is administered by the Ministry of Commerce and Industry[1]

Foreign Trade can be divided into following three groups:-

1. **Import Trade**: Import trade refers to purchase of goods by one country from another country or inflow of goods and services from foreign country to home country.
2. **Export Trade**: Export trade refers to the sale of goods by one country to another country or outflow of goods from home country to foreign country.
3. **Entrepot Trade**: Entrepot trade is also known as Re-export. It refers to purchase of goods from one country and then selling them to another country after some processing operations.

International or Foreign trade is recognized as the most significant determinants of economic development of a country, all over the world. The foreign trade of a country consists of inward (import) and outward (export) movement of goods and services, which results into outflow and inflow of foreign exchange. Thus it is also called EXIM Trade.

[1] Gaurav Akrani(2011) ‘What is Foreign Trade’

For providing, regulating and creating necessary environment for its orderly growth, several Acts have been put in place. The foreign trade of India is governed by the Foreign Trade (Development & Regulation) Act, 1992 and the rules and orders issued there under. Payments for import and export transactions are governed by Foreign Exchange Management Act, 1999. Customs Act, 1962 governs the physical movement of goods and services through various modes of transportation.

To make India a quality producer and exporter of goods and services, apart from projecting such image, an important Act – Exports (Quality control & inspection) Act, 1963 has been in vogue. Developmental pace of foreign trade is dependent on the Export-Import Policy adopted by the country too. Even the EXIM Policy 2002-2007 lays its stress to simplify procedures, sharply, to further reduce transaction costs.

1.5 Manufacturing Trade

As in most advanced economies, the service sector accounts for the largest share of output and employment like U.K, United States. However, key segments in the service sector depend importantly on manufactured goods, especially those related to information processing. At the same time, key innovations developed by firms in the manufacturing sector have been adopted by service-sector firms, enabling them to achieve substantial gains in efficiency and productivity. For example, research has found that big-box retailers such as Wal-Mart and Target have improved the nation's productivity by significantly increasing the efficiency of the supply chain from manufacturer to retailer. This supply chain revolution—termed "just in time" inventories— was started by Toyota, a large global manufacturer.

The total share of the manufactured goods of India in the total exports of India was about 39 per cent in 1950-51 which includes gunny bags, cotton piece goods, and gunny clothes. These all were basically agriculture-based products. However,

complete and detailed data is not available. India's Industrial base too was small. In 1960-61 the total share of manufactured products of India increased to 45.4% and before economic reforms in 1990-91 it boosted to 72.9% and reached its peak in 2000-01 to 78%, thereafter downward trend was set in and it was 67.2 per cent in 2009-10.

The study considers manufactured exports in an inclusive manner are Drugs, Pharma, Engineering and Electronics; Gems & Jewellery, Fine Chemicals, Other Basic Chemicals; Plastic & Linoleum; Textiles - Cotton Yarn/Man–made Yarn/Fabrics/Made-ups, RMG of all Textiles; and Leather, Jute, Carpets and Handicrafts.

As per planning commission report manufacturing Exports will be around 25% of GDP in 2025 from present levels. Among all the manufacturing exports engineering products came out as the most dynamic sector with its 39.8 per cent share in total manufacturing export in 2010. After engineering products other major contributor to India's manufacturing export performance is Gems and Jewellery, with a total share of 22.2%. Textiles are placed at 3rd place with total share of 13.9% in the total manufacturing exports.

1.6 Role of Financial Development in Manufacturing Trade

Trade and finance have been connected in the literature in at two different ways, which can be mainly characterized as supply-side and demand-side. In an important paper, Rajan and Zingales (2003) emphasize the supply-side role of interest groups, and especially the vested interests of incumbent industrialists and financial intermediaries. Incumbents, worried by the threat of entry, have strong incentives to resist financial development. These incentives are weakened if a country becomes more open to foreign competition or to international flows of capital. In this view,

goods market openness can improve the supply of external finance, because it aligns the interests of the economically powerful more closely with financial development. In contrast, Svaleryd and Vlachos (2002) emphasize the role of risk diversification. To the extent that openness is associated with greater risks, such as increased exposure to external demand shocks or foreign competition, it will create new demands for external finance. Firms will need credit in order to overcome short-term cash flow problems and adverse shocks. In this view, the effects of trade on finance are likely to work primarily through the demand side.

There are a number of channels through which financial development can be used into comparative advantage. One of them is based on the liquidity constraints that most firms face. According to this argument, when financial institution is weak and inefficient, firms in export-oriented sectors are burdened by significant liquidity constraints that prevent a subset of productive firms to enter the foreign market (Chaney, 2005). On the other hand, if firms face less restrictive credit constraints as, for example, a result of financial sector reforms, then investment can increase more in response to a lowering of variable export costs and all firms with productivity above a certain level become exporters (Melitz, 2003). Therefore, the main prediction of papers suggests that financial development should promote production first and then trade. The relationships of financial development and trade may vary with the initial level of financial development as a higher level of financial development makes the firm closer to the cut-off level and thus makes entry more probable especially if the conditions on the local financial market are favorable (Berthou, 2007). Beck (2002) also suggests that financial development and trade relationships may also be subject to economies of scale. A sector with scale economies profits more from a higher level of financial development than a sector without economies of scale. Countries with

better developed financial sectors have a comparative advantage in sectors with high scale economies and are therefore net exporters. Finally financial development and trade hypothesis is also highly conditional on a country's pre-existing circumstance such as economic, historic, cultural or geographic specificities (Apoteker and Crozet, 2003).

Financial development plays a key role in determining trade performance. The great trade collapse experienced in 2009 is one of the most striking phenomenon observed in recent years. According to the World Trade Organization (WTO), the volume of world trade fell by 12% in 2009. The decline in the merchandise export volumes was particularly severe in North America (-15%) and Europe (-15%) compared to South America (-8%) and Asia (-11%). According to Francois and Woerz (2009), the decline in trade flows was more dramatic for manufactured products (-15.5%), especially n durable goods such as automotive products (-32%) and industrial machinery (-29%), than for agricultural goods (-3%) or fuel and mining products (-4.5%). More interestingly, the slump in world trade appears much stronger than the contraction in Gross Domestic Product (GDP), which amounted to -4.6% in 2009. The recent drop in export volumes was steeper than those witnessed in 1965 (-7%), 1982 (-2%) and 2001 (-0.2%), known as three main previous episodes of declining trade. It was also more severe than the fall in world trade observed during the Great Depression of the 1930s. While the decline in trade experienced during the Great Depression is largely due to the implementation of trade barriers, the 2009 trade collapse cannot be attributed to increased protectionism.

The main explanation for the magnitude of the trade collapse, according to WTO, relates to the key role of the recent crisis that affected financial systems worldwide. The 2007-2008 financial crises have multiple dimensions. First, a large number of

banks suffered liquidity and solvency problems, inducing failures or massive state bailouts. In addition, a global credit crunch occurred, especially after the bankruptcy of Lehman Brothers (Aisen and Franken, 2010). The crisis also affected financial markets. Suffering from a crisis of confidence, investors fled stock markets for less risky markets, notably sovereign bond markets. According to the World Bank, world stock market capitalization declined by 30000 billion dollars in 2008 (a decline representing nearly 50% of the global GDP).

1.7 Rationale of the Study

The empirical growth literature has identified that in the group of the macroeconomic variables the level of financial development and the degree of openness are highly correlated with growth performance across countries. This study explores a possible link between financial development and trade balance in manufactures of India. Specifically, it analyzes theoretically a channel through which the economy-wide level of financial development of India determines the trade balance in manufactures. Exploring the link between financial development and trade in manufactures in India will be interesting for several reasons. First, if we find that the level of financial development has an effect on the structure of the trade balance, this will underline the importance of financial sector development for economic development beyond its positive impact on economic growth; and therefore, will increases the priority of financial sector reforms on policy maker's agendas. Second, exploring the links between financial development and the structure of international trade will also have implications for the theory of international trade. The **Heckscher–Ohlin** model predicts that trade flows based on an economy's endowments of labor, land and physical capital. In the **Ricardian** model technological differences across countries explain international trade flows. This study explores theoretically and empirically

whether the financial development of India helps predicts manufactures trade balance. A possible link between financial development and international trade has policy implications. On the one hand, reforming the financial sector might have implications for the trade balance if the level of financial development is a determinant of countries' comparative advantage. On the other hand, the effect of trade reforms on the level and structure of the trade balance might depend on the level of financial development.

1.8 Objectives of the Study

1. To measure the performance of Manufacturing Exports and Trade Balance of India.
2. To examine the role of Financial Development in the performance of Manufacturing Export and Trade Balance.

1.9 Hypotheses of the Study

- **Hypothesis 1**

H0: There is no significant relationship between financial development and manufacturing trade.

H1: There is a significant relationship between financial development and manufacturing trade.

- **Hypothesis 2**

H0: There is no significant relationship between financial development and Trade balance.

H1: There is significant relationship between financial development and Trade balance.

1.10 Organization of the Study

- Introduction
- Review of Literature
- Research Methodology
- Performance of Manufacturing Exports and Trade Balance of India.
- Role of Financial Development in the performance of Manufacturing Export and Trade Balance
- Major findings and Policy Implications of the study
- References
- Appendixes