ROLE OF FINACIAL SYSTEM IN INDIAN ECONOMY

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ABSTRACT

Finance holds the key to achieving long-term growth prospective for any country. As the economy grows and becomes more complex and market-oriented, the financial sector starts playing a crucial role in supporting growth by channeling domestic and foreign capital into productive investments. Increasing access to the financial system is also a main concern for making growth more balanced and sustainable, from both economic and social perspectives.

Financial systems one of the industries in an economy. It performs certain essential functions for the economy including maintenance of payment system, collection & allocation of the savings of society and creation of a variety of stores of wealth to suit the preferences of savers. It is a link between the saving & investments by providing the mechanism through which savings of savers are pooled and are put into the hands of those able & willing to invest by financial intermidateres. The role of financial system is thus, to promote savings and their channelization in the economy through financial assets that are more productive than the physical assets. Developing countries attach great importance to financial sector development and deepening in the pursuit of their poverty reduction goal. By mobilizing savings, facilitating payments and trade of goods and services, and promoting efficient allocation of resources, the financial sector is seen as playing a critical role in facilitating economic growth and, directly through broadening access to finance and indirectly through growth, contributing to poverty reduction

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INTRODUCTION

INDIAN FINANCIAL SYSTEM

Meaning and definition of financial system:

The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether the mobilization of savings or their efficient, effective and equitable allocation for investment, it the access with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

According to Christy, the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires."

According to Robinson, the primary function of the system is " to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

A financial system or financial sector functions as an intermediary and facilitates the flow of funds from the areas of surplus to the deficit. It is a composition of various institutions, markets, regulations and laws, practices, money manager analyst, transactions and claims and liabilities.

Features of financial system

The features of a financial system are as follows

1. Financial system provides an ideal linkage between depositors and investors, thus encouraging both savings and investments.
2. Financial system facilitates expansion of financial markets over space and time.
3. Financial system promotes efficient allocation of financial resources for socially desirable and economically productive purposes.
4. Financial system influences both the quality and the pace of economic development.

CONSTITUENTS OF FINANCIAL SYSTEM

The financial system consists of four segments or components. These are: financial institutions, financial markets and financial services.

1. **Financial institutions:** Financial institutions are intermediaries that mobilize savings & facilitate the allocation of funds in an efficient manner.

Financial institutions can be classified as banking & non-banking financial institutions. Banking institutions are creators of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs) & non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit. Financial institutions can also be classified as term-finance institutions such as the industrial development bank of India (IDBI), industrial credit & Investment Corporation of India (ICICI), industrial financial corporation of India (IFCI), small industries development bank of India (SIDBI) & industrial investment bank of India (IIBI).

2. Financial markets:

Financial markets are a mechanism enabling participants to deal in financial claims.

The markets also provide a facility in which their demands & requirements interact to set a price for such claims. The main organized financial markets in India are the money market & capital market. The first is a market for short-term securities. Money market is a market for dealing with financial assets & securities which have a maturity period of upto one year. While the second is a market for long term securities, that is, securities having a maturity period of one year or more. The capital market is a market for financial assets which have a long or indefinite maturity.

Money market consists of:

Call money market:

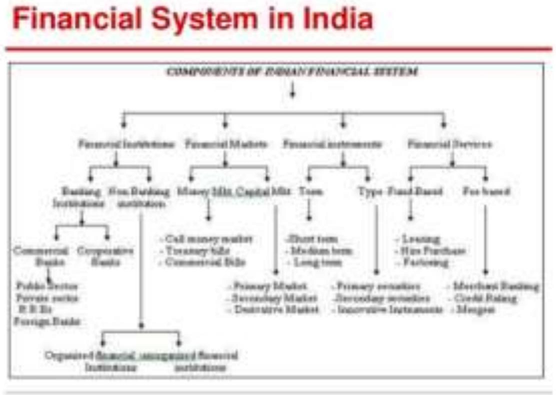
Call money market is a market for extremely short period loans say one day to fourteen days. It is highly liquid.

Commercial bills market:

It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

Treasury bills market:
It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the government. It is highly liquid because its repayment is guaranteed by the government.
Short-term loan market:
It is a market where short- term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market.
Capital market consists of:
Industrial securities market:
It is a market for industrial securities namely equity shares or ordinary shares, preference shares & debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into primary & secondary market.
Government securities market:
It is otherwise called gilt-edged securities market. It is a market where government securities are traded. In India there are many kinds of govt securities- short-term & long-term. Long-term securities are traded in this market while short term securities are traded in the money market.
Long-term loans market:
Development banks & commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long-term loans market may further be classified into:
Term loans market
Mortgages market
Financial guarantees market
3**. Financial Instruments**:
Financial instruments refer to that document which represents financial claims on assets. As discussed earlier, financial assets refers to a claim to the repayment of certain sum of money at the end of specified period together with interest or dividend. Examples : bills of exchange, promissory notes, treasury bills, government bonds, deposit receipts, shares debentures etc.
Financial instruments can also be called financial securities. Financial securities can be classified into:
i. Primary or direct securities
ii. Secondary or indirect securities.
Primary securities
These are securities directly issued by the ultimate investors to the ultimate savers. Examples, shares and debentures issued directly to the public.
Secondary securities
These are securities issued by some intermediaries called financial intermediaries to the ultimate savers. E.g. unit trust of India and Mutual funds issue securities in the form of units to the public and money pooled is invested in companies.
Again these securities may be classified on the basis of duration as follows:
i. Short-term securities
ii. Medium-term securities
iii. Long-term securities.

Short-term securities are those which mature within a period of one year. E.g. Bills of exchange, treasury bills, etc. medium term securities are those which have a maturity period ranging between one and five years.



e.g. Debentures maturing within a period of 5 years. Long-term securities are those which have a maturity period of more than five years. E.g. government Bonds maturing after 10 years.

Structure and Function of of Indian Financial System

Financial System is a set of institutional arrangements through which financial surpluses in the economy are mobilised from surplus units and transferred to deficit spenders.

The institutional arrangements include all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments of all kinds and the organisations as well as the manner of operations of financial markets and institutions of all descriptions.

Thus, there are three main constituents of financial system:

(a) Financial Assets

(b) Financial Markets, and

(c) Financial Institutions.

Financial assets are subdivided under two heads:

Primary securities and secondary securities. The former are financial claims against real-sector units, for example, bills, bonds, equities etc. They are created by real-sector units as ultimate borrowers for raising funds to finance their deficit spending. The secondary securities are financial claims issued by financial institutions or intermediaries against themselves to raise funds from public. For examples, bank deposits, life insurance policies, UTI units, IDBI bonds etc.

Functions of Financial System:

The financial system helps production, capital accumulation, and growth by (i) encouraging savings, (ii) mobilising them, and (iii) allocating them among alternative uses and users. Each of these functions is important and the efficiency of a given financial system depends on how well it performs each of these functions.

(i) Encourage Savings:

Financial system promotes savings by providing a wide array of financial assets as stores of value aided by the services of financial markets and intermediaries of various kinds. For wealth holders, all this offers ample choice of portfolios with attractive combinations of income, safety and yield.

With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is directly related to both financial assets and financial institutions. That is, financial progress generally insures larger savings out of the same level of real income.

As stores of value, financial assets command certain advantages over tangible assets (physical capital, inventories of goods, etc.) they are convenient to hold, or easily storable, more liquid, that is more easily encashable, more easily divisible, and less risky.

(ii) Mobilisation of Savings:

Financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instance, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings.

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(iii) Allocation of Funds:

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. With modem financial development and new financial assets, institutions and markets have come to be organised, which are replaying an increasingly important role in the provision of credit.

Structure of Indian Financial System:

Financial system operates through financial markets and institutions.

The Indian Financial system (financial markets) is broadly divided under two heads:

(i) Indian Money Market

(ii) Indian Capital Market

The Indian money market is the market in which short-term funds are borrowed and lent. The money market does not deal in cash, or money but in bills of exchange, grade bills and treasury bills and other instruments. The capital market in India on the other hand is the market for the medium term and long term funds.

Role of financial system in economic development of a country

<u>Finance</u>

Relationship between financial system and economic development

The development of any country depends on the economic growth the country achieves over a period of time. Economic growth deals about investment and production and also the extent of Gross Domestic Product in a country. Only when this grows, the people will experience growth in the form of improved standard of living, namely economic development.

Role of financial system in economic development of a country

The following are the **roles of financial system** in the economic development of a country.

Savings-investment relationship

To attain economic development, a country needs more investment and production. This can happen only when there is a facility for savings. As, such savings are channelized to productive resources in the form of investment. Here, the role of financial institutions is important, since they induce the public to save by offering attractive interest rates. These savings are channelized by lending to various business concerns which are involved in production and distribution.

Financial systems help in growth of capital market

Any business requires two types of capital namely, fixed capital and working capital. Fixed capital is used for investment in fixed assets, like plant and machinery. While working capital is used for the day-to-day running of business. It is also used for purchase of raw materials and converting them into finished products.

- **Fixed capital** is raised through capital market by the issue of debentures and shares. Public and other financial institutions invest in them in order to get a good return with minimized risks.
- For **working capital**, we have money market, where short-term loans could be raised by the businessmen through the issue of various credit instruments such as bills, promissory notes, etc.

Foreign exchange market enables exporters and importers to receive and raise funds for settling transactions. It also enables banks to borrow from and lend to different types of customers in various foreign currencies. The market also provides opportunities for the banks to invest their short term idle funds to earn profits. Even governments are benefited as they can meet their foreign exchange requirements through this market.

Government Securities market

Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions. The budgetary gap is filled only with the help of government securities market. Thus, the capital market,money market along with foreign exchange market and government securities market enable businessmen, industrialists as well as governments to meet their credit requirements. In this way, the development of the economy is ensured by the financial system.

Financial system helps in Infrastructure and Growth

Economic development of any country depends on the infrastructure facility available in the country. In the absence of key industries like coal, power and oil, development of other industries will be hampered. It is here that the financial services play a crucial role by providing funds for the growth of infrastructure industries. Private sector will find it difficult to raise the huge capital needed for setting up infrastructure industries. For a long time, infrastructure industries were started only by the government in India. But now, with the policy of economic liberalization, more private sector industries have come forward to start infrastructure industry. The Development Banks and the Merchant banks help in raising capital for these industries.

Financial system helps in development of Trade

The financial system helps in the promotion of both domestic and foreign trade. The financial institutions finance traders and the financial market helps in discounting financial instruments such as bills. Foreign trade is promoted due to per-shipment and post-shipment finance by commercial banks. They also issue Letter of Credit in favor of the importer. Thus, the precious foreign exchange is earned by the country because of the presence of financial system. The best part of the financial system is that the seller or the buyer do not meet each other and the documents are negotiated through the bank. In this manner, the financial system not only helps the traders but also various financial institutions. Some of the capital goods are sold through hire purchase and installment system, both in the domestic and foreign trade. As a result of all these, the growth of the country is speeded up.

Employment Growth is boosted by financial system

The presence of financial system will generate more employment opportunities in the country. The money market which is a part of financial system, provides working capital to the businessmen and manufacturers due to which production increases, resulting in generating more employment opportunities. With competition picking up in various sectors, the service sector such as sales, marketing, advertisement, etc., also pick up, leading to more employment opportunities. Various financial services such as leasing, factoring, merchant banking, etc., will also generate more employment. The growth of trade in the country also induces employment opportunities. Financing by Venture capital provides additional opportunities for techno-based industries and employment.

Venture Capital

There are various reasons for lack of growth of venture capital companies in India. The economic development of a country will be rapid when more ventures are promoted which require modern technology and venture capital. Venture capital cannot be provided by individual companies as it involves more risks. It is only through financial system, more financial institutions will contribute a part of their investable funds for the promotion of new ventures. Thus, financial system enables the creation of venture capital.

Financial system ensures Balanced growth

Economic development requires a balanced growth which means growth in all the sectors simultaneously. Primary sector, secondary sector and tertiary sector require adequate funds for their growth. The financial system in the country will be geared up by the authorities in such a way that the available funds will be distributed to all the sectors in such a manner, that there will be a balanced growth in industries, agriculture and service sectors.

Financial system helps in fiscal discipline and control of economy

It is through the financial system, that the government can create a congenial business atmosphere so that neither too much of inflation nor depression is experienced. The industries should be given suitable protection through the financial system so that their credit requirements will be met even during the difficult period. The government on its part, can raise adequate resources to meet its financial commitments so that economic development is not hampered. The government can also regulate the financial system through suitable legislation so that unwanted or speculative transactions could be avoided. The growth of black money could also be minimized.

Financial system's role in Balanced regional development

Through the financial system, backward areas could be developed by providing various concessions or sops.

CONCLUSION

Based on this paper The Indian financial system has undergone structural transformation over the past decade. The financial sector has acquired strength, efficiency and stability by the combined effect of competition, regulatory measures, and policy environment. While competition, consolidation and convergence have been recognized as the key drivers of the banking sector in the coming years

Financial system plays a significant role in the economic development of a country. Financial markets present three major efficiencies for the sake of development and they are allocation, information, and operational efficiency. Financial institutions are profit maximizing businesses that earn profits by acquiring funds at interest rates lower than they earn on their assets.

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