International Journal of Multidisciplinary Research and Development
Online ISSN: 2349-4182, Print ISSN: 2349-5979
Impact Factor: RJIF 5.72
Received: 10-07-2018; Accepted: 08-08-2018
www.allsubjectjournal.com
Volume 5 Issue 8; August 2018; Page No. 100-107

Role of financial system in economic development of a country

Dr. G Suresh Babu[1]
[1] Ph.D. Associate Professor, Department of Commerce, Govt. Degree & PG College, Puttur, Chittoor, Andhra Pradesh, India

Abstract
The financial system of a country is an important tool for economic development of the country. It helps in creation of wealth by linking the savings with investments. It also facilitates the flow of funds from the households (savers) to business firms (inventors) to aid in wealth creation and development of both the parties. Not only that, the financial system of a country is concerned with the allocation of savings, provision of funds, facilitating the financial transactions, developing the financial markets, provision of legal financial framework and provision of financial and advisory services in the country. A financial system comprise of financial institutions, financial services, financial markets and financial instruments. These constituents are closely related and work in conjunction with each others.
This paper has dealt with discussed on some issues that are related to Indian financial system.

Keywords: financial system. Economic development, allocation, diversified, financial framework

Introduction

According to Prof. Robinson, the primary function of a financial system is “to provide a link between savings and investment for creation of wealth and to permit portfolio adjustment in the composition of existing wealth”.
The financial system plays a vital role in the economic development of a country. It encourages both savings and investment and also creates links between savers and investors and also facilitates the expansion of financial markets and aids in financial deepening and broadening. The financial system accelerates the rate and volume of savings through provision of various financial instruments and efficient mobilization of savings. It aids in increasing the national output of the country by providing the funds to the corporate customers to expand their respective business. It also protects the interests of the investors and ensures the smooth financial transitions through regulatory bodies such as RBI, SEBI etc.

Fig 1

The financial system helps the economic development and raising the standard of living of people. It helps to promote the development of weaker section of the society through rural development banks and co-operative societies. The financial institutions helps the customers to make better financial decisions by providing effective financial as well as advisory services. It aids in the increase in financial assets as a percentage of GDP and increasing the number of participants in the financial system.

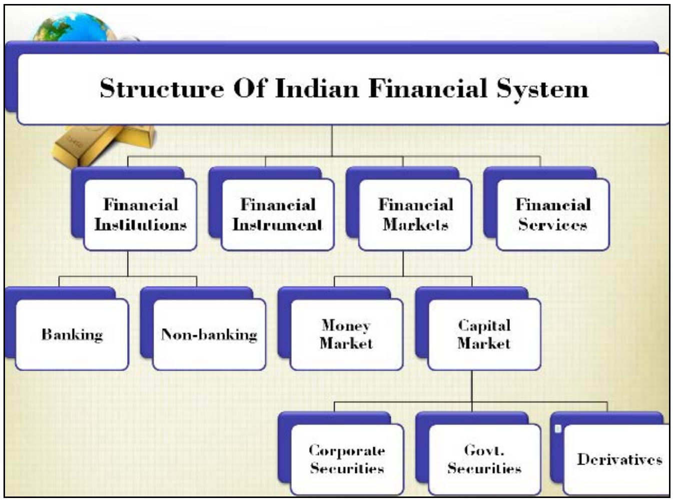

Fig 2

Financial system in India

A financial system is the system that covers financial transactions and the exchange of money between investors, lender and borrowers. A financial system can be defined at the global, regional or firm specific level. Financial systems are made of intricate and complex models that portray financial services, institutions and markets that link depositors with investors.

Fig 3

The financial system is characterized by the presence of integrated, organized and regulated financial markets and institutions that meet the short term and long term financial needs of both the household and corporate sector. Both financial markets and financial institutions play an important role in the financial system by rendering various financial services to the community.

The Indian financial sector today is significantly different from what it used to be a few decades back, in the 1970s and 1980s. The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. Financial markets were segmented and under developed coupled with paucity of instruments.

The current financial regulatory system

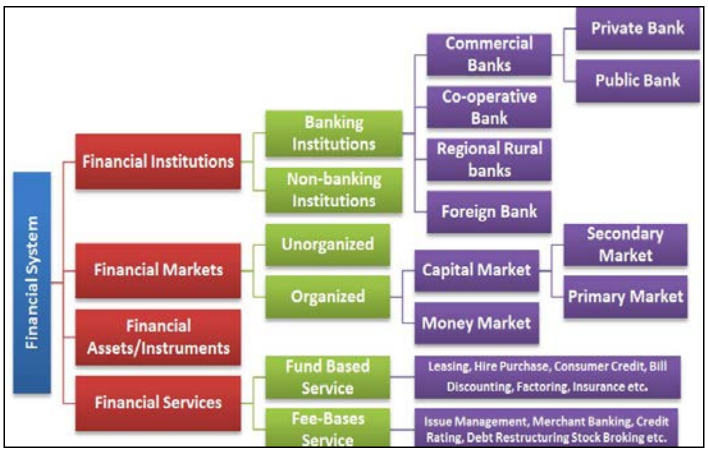

Fig 4

1. Financial institutions

The financial institutions are intermediaries of financial markets which facilitate financial transactions between individuals and financial customers. The financial institutions have collects the money from individuals and invests that money in financial assets such as stocks, bonds, bank deposits and loans etc., The following are the financial institutions –

Fig 5

Banking institutions: These are the banks and credit unions that collect money from the public in returns of interest on money deposits and use that money to advance loans of financial customers.

Non-banking institutions: These are brokerage firms, insurance and mutual funds companies that cannot college money deposits but can sell financial products to financial customers.

Regulatory institutions: RBI, SEBI, IRDA etc., which regulate the financial markets and protect the interests of the investors.

Intermediaries: Commercial banks, that provide the short term loans and other financial services to the individuals and corporate customers.

Non-intermediaries: Financial institutions like NABARD, IDBI etc that provide long-term loans to corporate customers.

2. Financial markets

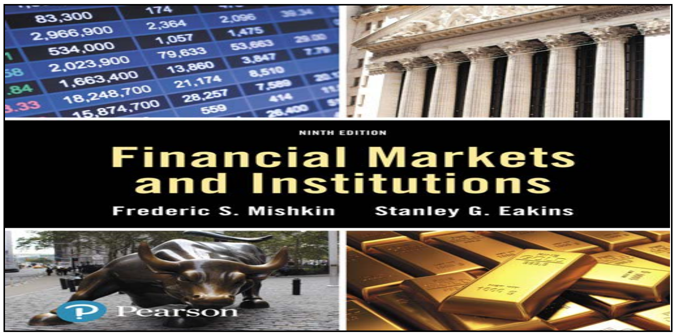

Fig 6

Financial markets are the places where the buyers and sellers participate in trading of assets such as shares, bonds, currencies and other financial instruments. A financial market may be further divided into capital market and money market. While the capital market deals in long term securities having maturity period of more than one year, the money market deals with the short-terms debt instruments having maturity period of less than one year.

3. Financial assets/instruments

Fig 7

Financial assets include cash deposits, checks, loans, accounts receivable, letter of credit, bank notes and all other financial instruments that provide a claim against a person/financial Institution to pay either a specific amount on a certain future date or to pay the principal amount along with interest.

4. Financial services

Fig 8

The financial services are concerned with the design and delivery of financial instruments and advisory services to individuals and businesses with the area of banking and related institutions, personal financial planning, leasing, investment, assets, insurance etc.,

Components Indian financial system

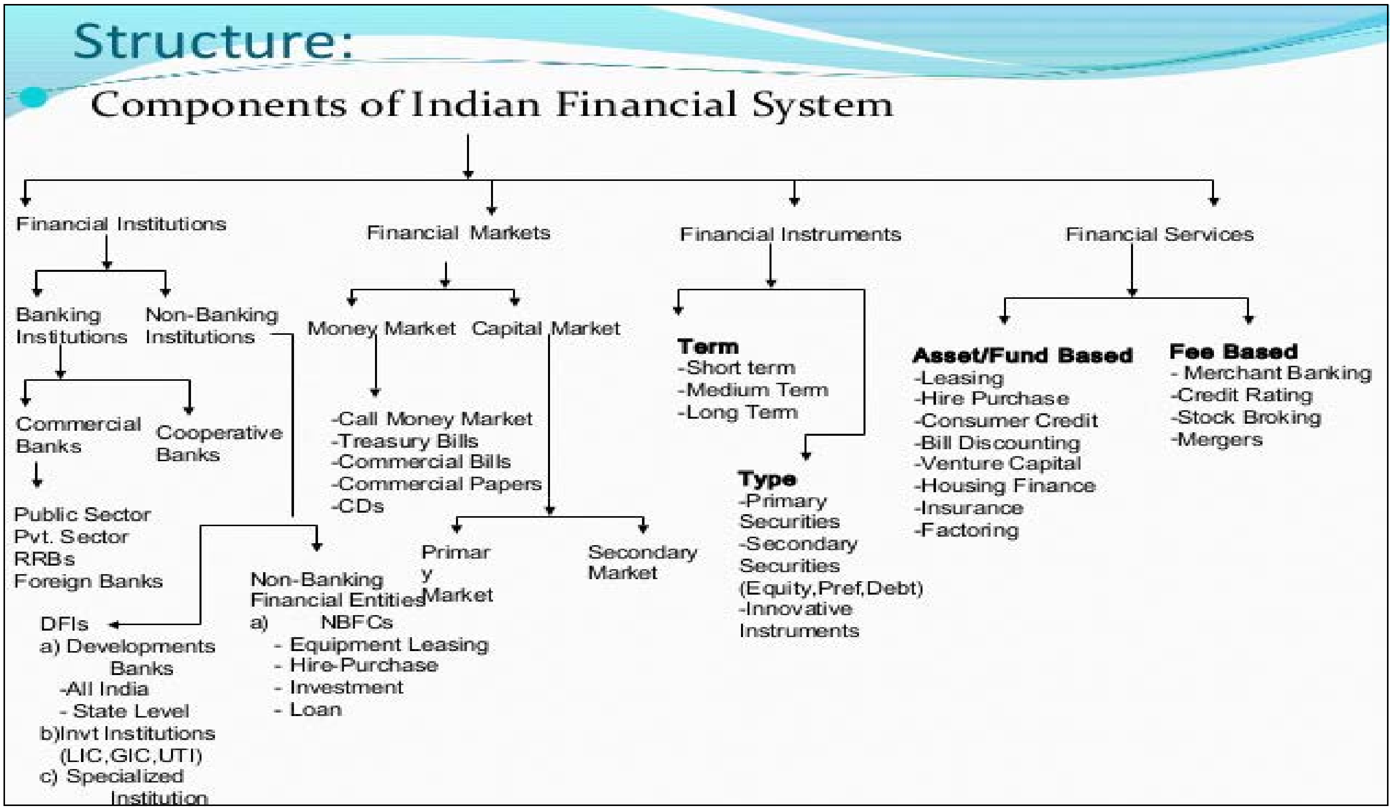

Fig 9

The financial system bridges the gap between savings and investment through efficient mobilization and allocation of surplus fund and also helps to a business in capital formation. It helps in minimizing the risk and allocating the risk efficiently and helps a business to liquidate tied up the funds. It facilitates financial transactions through provision of various financial instruments and facilitates the trading of financial assets/instruments by developing and regulating financial markets.

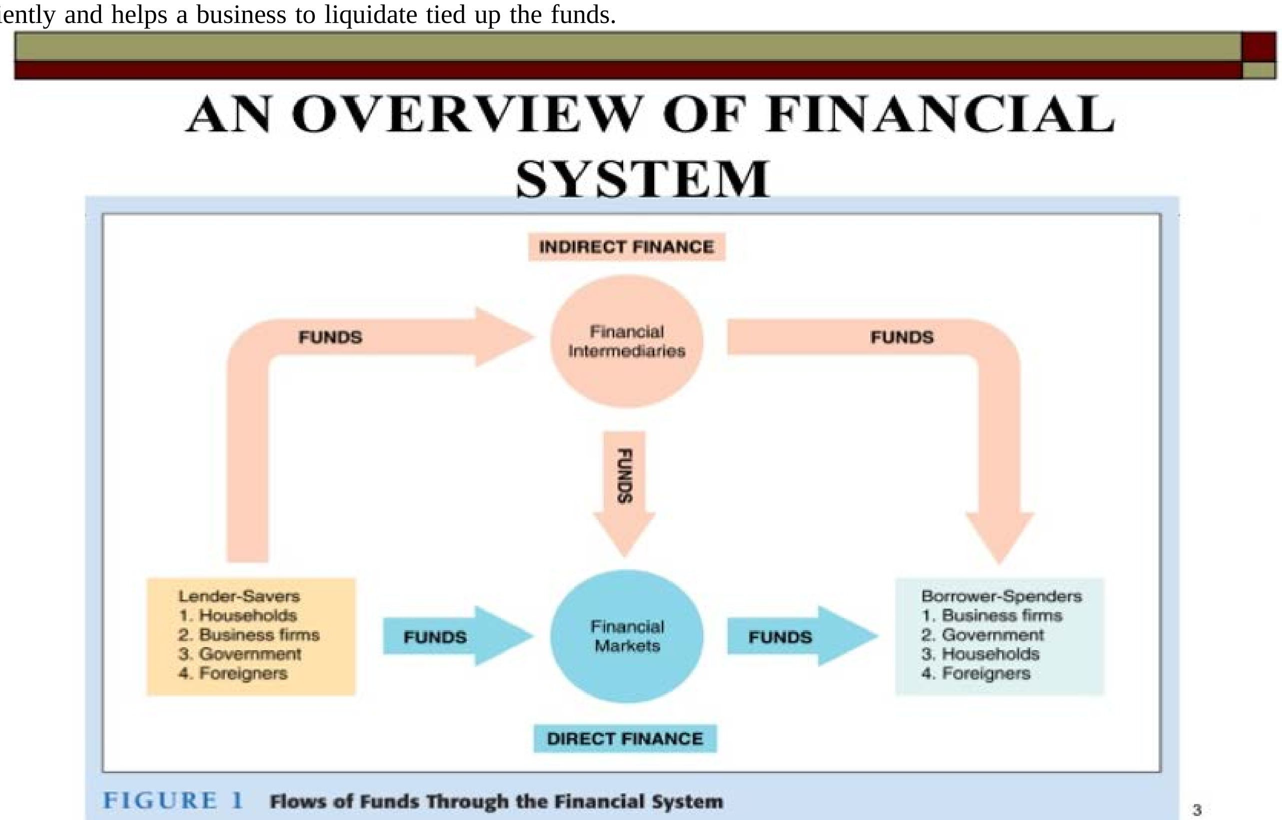

Fig 10

Review of literature

IMF (2017) [1], said that, “India's financial sector is facing considerable challenges with high non-performing assets and slow deleveraging and repair of corporate balance sheets testing the resilience of the banking system and holding back growth”

Sanjeev kumar (2017) [2], stated that, “India has a financial system that is regulated by self-governing regulators in the sectors of banking, insurance, capital markets and various sectors”

Vaishali Doshi (2016) [3], stated that, “Economic development of a nation relies on the soundness of the nation’s financial system”

Objectives of the study

1. To study the role and importance of financial system in the economic development of a country
2. To describe the weaknesses of Indian financial system
3. To explain the recent developments in the Indian financial system

Methodology of the study

The data and information for this study is collected from secondary sources like, reputed journals, magazines, newspapers, reports and websites.

Significance of the study

The ‘financial system’ is concerned with the mobilization of the savings of the public and providing of necessary funds to the needy persons and institutions for enabling the production of goods and/or for provision of services and allows the exchange of funds between lenders, investors, and borrowers. The financial system that facilitates the movement of finance from the persons who have surplus funds to the persons who need it is called as financial system. It consists of complex, closely related services, markets, and institutions used to provide an efficient and regular linkage between investors and depositors. The financial systems operate at national, global, and firm-specific levels. It includes the public, private and government spaces and financial instruments which can relate to countless assets and liabilities.

Fig 11

1. 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.

2. Financial systems help in growth of capital market

Every 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.
- Working capital is getting through 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.

3. Foreign exchange market

It enables the exporters and importers to receive and raise the 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.

4. 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. 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.

5. 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.

6. 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

7. 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.

8. 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.

9. 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.

10. 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.

11. Financial system's role in balanced regional development

Through the financial system, backward areas could be developed by providing various concessions. This ensures a balanced development throughout the country and this will mitigate political or any other kind of disturbances in the country. It will also check migration of rural population towards towns and cities.

12. Attracting foreign capital

Financial system promotes capital market. A dynamic capital market is capable of attracting funds both from domestic and abroad. With more capital, investment will expand and this will speed up the economic development of a country.

13. Economic Integration

Financial systems of different countries are capable of promoting economic integration. This means that in all those countries, there will be common economic policies, such as common investment, trade, commerce, commercial law, employment legislation etc.

14. Political stability

The political conditions in all the countries with a developed financial system will be stable. Unstable political environment will not only affect their financial system but also their economic development.

15. Uniform interest rates

The financial system is capable of bringing a uniform interest rate throughout the country by which there will be balanced movement of funds between centers which will ensure availability of capital for all kinds of industries

16. Electronic development

Due to the development of technology and the introduction of computers in the financial system, the transactions have increased manifold bringing in changes for the all-round development of the country. The promotion of World Trade Organization (WTO) has further improved international trade and the financial system in all its member countries.

Limitations or weaknesses of Indian financial system

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a more growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

1. Lack of co-ordination between different financial institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also having the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

2. Monopolistic market structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolized the mutual fund industry.

3. Dominance of development banks in industrial financing

The development banks constitutes the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds, from their sponsors. As such, they fail to mobilize the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country

4. Inactive and erratic capital market

The important function of any capital market is to promote economic development through mobilization of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate companies are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

5. Imprudent financial practice

The dominance of development banks has developed imprudent financial practice among corporate companies. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crises, these financial institutions permit a greater use of debt than a warranted. It is against the traditional concept of a sound capital structure.

A strategy for change

In recent years, a series of expert committees developed a consensus around a strategy for change. The reforms proposed by these committees require legislative changes, leading India's Ministry of Finance to set up the Financial Sector Legislative Reforms Commission to rewrite the laws. After two years of deliberations and consultation, the commission submitted the proposed Indian Financial Code.

This draft law is a new, modern, coherent, and consistent fram ework based on the rule of law, independence, accountability, and an overriding objective of consumer protection. It replaces most existing Indian financial laws. It outlines the powers of agencies that regulate the financial sector while recognizing that for those regulators to be effective, they must have clear objectives and be held accountable for achieving those objectives.

Any attempts at building a government agency must begin with a set of hypotheses about the problem in the world that this agency is required to solve. Alongside this market-failure perspective, there is value in looking at reform from the perspective of public choice theory, which views bureaucrats and politicians as self-interested.

The Indian financial sector has witnessed tremendous improvement in its performance as compared to other emerging market economies. Substantial cost-efficiency and profitability has been achieved in the post reform period. Other segments of financial market, particularly, Indian stock market is also comparable to the international stock markets in terms of turnover ratio. Presently, India has third largest investor base in the world. Indian Stock market trading and settlement system are of world class. India has one of the world's lowest transaction costs based on screen-based transactions and paperless trading.

Recent developments of Indian financial system

India has a financial system that is controlled by self-governing regulators in the sectors of banking, insurance, capital markets, opposition and various services sectors. In a number of sectors the government plays the role of regulator. Ministry of Finance, Government of India looks after financial sector in India.

The top 5 developments in Indian financial system in 2016.

1. Withdrawal of legal tender status for Rs 500 and Rs 1000 notes
2. Setting up of the monetary policy committee
3. Passage of the goods and services tax bill
4. Passage of the insolvency and bankruptcy code
5. Thrust towards digitization of government payments

1. Withdrawal of legal tender status for Rs 500 and Rs 1000 notes

"To break the grip of corruption and black money, we have decided that the five hundred rupee and thousand rupee currency notes presently in use will no longer be legal tender from midnight tonight that is 8th November 2016…."With these words the Indian Prime Minister in one stroke announced the withdrawal of what constituted 86% of Indian currency in circulation at that point in time. The announcement initially came with a list of caveats for exchange and withdrawal that have since seen frequent additions/revisions by the day and accompanied by stories of unprecedented disruptions to the daily life of citizens and businesses in the aftermath of the ban

2. Setting up of the monetary policy committee

October 4th, 2016 marked the first time that a committee, rather than one person, until then the RBI Governor, would decide the policy interest rates in the economy. Entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level, the Monetary Policy Committee was set-up with six members

– three nominated from the Central Government and three from the Reserve Bank of India, with the RBI Governor getting the casting vote in case of a tie.

3. Passage of the goods and services tax (GST) bill

Aimed at doing away with a host of Central and State taxes and ushering in a one tax regime for the entire country, both the Houses of Parliament passed the Goods & Services Tax Bill in August 2016, with the President giving his assent in September. Including most of the Central and State taxes such as the Value Added Tax (VAT), excise duty, service tax, central sales tax, additional customs duty and special additional duty of customs, GST would lead to a uniform consumption-based tax structure across the land for almost all goods and services and the government has set a deadline of April 1, 2017 to roll this out. GST implementation would integrate the economy and provide for a common national market that enables businesses to leverage a simplified tax regime

4. Passage of the insolvency and bankruptcy code

In May 2016, both Houses of the Parliament passed the Insolvency and Bankruptcy Code that set in motion a national bankruptcy law to deal with insolvencies. The new law, which does away with at least 12 different rules, some of which are centuries old, is expected to usher in an effective bankruptcy resolution system that improves the ease of doing business in India. The Central Government in December notified the final regulations related to the insolvency resolution process under the Liquidation and Bankruptcy Code 2016, paving way for the operationalization of the 10-member Liquidation and Bankruptcy Board (IBBI).

5. Thrust towards digitization of government payments

The year 2016 saw extensive measures to incentivize greater implementation of digital payments with an all-round push by different Ministries and controllers. For instance, the Ministry of Electronics and Information Technology laid out Procedures for Acceptance of Electronic Payments and Receipts in November 2016 that covers a time bound process for the integration of digital payments and receipts connecting all Government divisions. It has set an ambitious deadline of 31 December 2016 by which 90% of outflows and receipts of all Government Divisions are to be made online.

Conclusion

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. In this environment, leaders are biased toward decisions that keep them in a comfortable position. In the capital market, the progress of reforms has been impressive during the nineties. However, certain refinements are needed to bring the Indian markets on par with the major international markets.

Hence, it can be said that, a financial system provides a platform to the lenders and borrowers to interact with each other for their mutual benefits. The ultimate profits of this interaction come in the form of capital accumulation and economic development of the country.

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