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Role of Financial System in India

Dr. Mahesh V. Shinde[1], Dr. Dipak D. Shinde[2]

[1]HOD Economics, D.M.S. Mandal's, Bhaurao Kakatkar College, Belgaum, Karnatka.
[2]HOD Economics Sanskar Mandir's, Arts and Commerce College, Warje, Pune, Maharashtra

Abstract

The Financial System plays a vital role in the economic development and raising the standard of living of people of a country. It helps to promote the development of weaker section of the society through rural development banks and co-operative societies. The economic development of any country depends upon the existence of a well-organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well-being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development. Therefore it is essential to study the role of Indian financial system in economic development of a country. This study basically depends upon secondary sources i.e. books, journals, reports, study materials, newspapers, internet etc. It was concluded that the financial system is of crucial significance for overall development of a country. The financial system is important for capital formation. The adequate capital formation is indispensable to a speedy economic development is universally recognized. The main function of financial system is the collection of saving and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. However, certain refinements are needed to bring the Indian markets on par with the major international markets.

Keywords: Financial system, role, development.

Introduction

The Financial System plays a vital role in the economic development and raising the standard of living of people of a country. It helps to promote the development of weaker section of the society through rural development banks and co-operative societies. The financial institutions help 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. 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 transactions through regulatory bodies such as RBI, SEBI etc.

Financial System in India

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 System includes various aspects such as financial markets, financial institutions, banking firms, financial services, financial intermediaries, financial assets and instruments, etc. All these are closely related and work in combination with each other. An efficient and innovative financial system is very essential for fast and continuous growth of the economy. The financial system promotes adequate allocation of monetary resources among economically desirable and available investment alternatives. An efficient financial system influences the quality as well as rate of economic growth and development. A well developed and properly regulated financial system ensures transfer of limited financial resources from different sections of the society.

Thus, it plays a very important role in overall functioning of whole economy. Dynamic and flexible financial markets are essential for creating balance and successful growth in financial system in a country. In India since independence, financial sector has been operating under strong Government control. For a period of more than four decades, Government had direct control over all the financial institutions and financial markets, which includes capital market and money market. During this period, Government of India directed various credit programs, control pricing of financial assets, framed different bank regulations and formed number of barriers for entering into different sectors. Government also restricted number of financial transactions as well as flow of funds within and outside the economy. All these resulted in growth of highly segmented, but inefficient financial markets. Both the money markets and capital markets remained underdeveloped.

Foreign exchange market was extremely narrow. This is mainly because of inflexible and strict restrictions under Foreign Exchange Regulation Act (FERA). Although financial sector grew significantly in regulated environment, it failed to achieve the expected level of efficiency and competency. Financial markets in India were highly segmented until the financial reforms were implemented from 1992 – 93. Large number of financial sector reforms was undertaken during1990s on the basis of recommendations given by Narasimhan Committee, 1991. The main objective was to build an effective and operationally efficient financial market in India. These reforms targeted fundamental restructuring in Indian economic system. These reforms included industrial deregulation, liberalization of policies relating to foreign direct investments, foreign institutional investments, trade liberalization, public enterpriser forms, etc. These transformations were initiated since 1992 after the implementation of new industrial and economic policy. The reforms were undertaken in various segments such as commercial banking, capital markets, foreign exchange management, mutual funds, investor protection, stock markets, non-banking financial services, etc. Primary focus of these reforms was to remove structural weaknesses and increase competitiveness. This would ensure development of domestic financial markets in order to link it to the global economy. These reforms also aimed at improving market efficiency, adequate and timely distribution of required information, market orientation for financial institutions, deregulation of interest rates, reduction of transaction costs, proper allocation of scare capital in productive avenues, reducing government intervention, improving financial feasibility and lastly, strengthening up financial institutions. The convertibility of Indian rupee on current account as well as dilution of FERA and its substitution by FEMA activated foreign exchange market in India. Further, these reforms also seek to build up an integrated financial market in order to reduce the speculative opportunities. This also helped in achieving higher level of efficiency in market operations. It increased effectiveness of monetary policies implemented in India. Past two decades have seen an exceptional growth in the geographical coverage of financial sector in India. Many reforms were undertaken for removing number of institutional barriers for free flow of capital across financial markets. But still, this has not been converted into complete integration of the markets. Even though, there is relatively free movement of capital and reduction of speculative opportunities, but still there are numerous corrections required. These corrections are required in both capital market as well as money market. Certain developments are also required in financial market.

Objectives of the Study

To study the role of financial system in India

Research Methodology

Financial system provides a useful link between investors and depositors. It encourages both rates of savings as well as investments. Overall economic activities are highly benefited by the development of financial system. This is because efficient financial markets help to mobilize hard earned savings and allocate those savings among the competing users. Therefore, this study is important. This study basically depends upon secondary sources i.e. Books, Journals, Reports, study materials, newspapers, internet etc.

Significance of Study

The financial system is business organization serving as a link between severs and investors and so help in the credit allocation process. Good financial system is vital to the functioning of an economy. If finance were to be described as the circulatory system of the economy, financial components (financial institutions (Intermediaries), financial instruments, financial markets and financial services) are its brain. They make decisions that tell scare capital where to and ensure that it is used most efficiently. It has been confirmed by research that countries with developed financial system grow faster and countries with weak ones are more likely to undergo financial crises.

Nature of Indian Financial System

1. Transfer Funds : • Financial system helps in transferring of financial resources from one person to another person. This system includes financial markets, financial intermediaries, financial assets and services which facilitates fund movements in an economy.
2. Mobilizes Saving : • It helps in allocation ideal lye resources with peoples into productive means. Financial system is the one which obtains funds from savers and provide it to those who are in need of it for various development purposes.
3. Risk Allocation : • Diversification of risk in an economy is important feature of financial system. Financial system allocates people’s funds in various sources due to which risk is diversified.
4. Facilitates Investment : • Financial system encourages investment by the peoples into different investment avenues. It provides various income generating investment options to peoples for investing their savings.
5. Enhances Liquidity : • Financial system helps in maintaining optimum liquidity in an economy. It facilities free movement of funds from households (savers) to corporate (investors) which ensures sufficient availability of funds.

6. Liability : • Liability, asset and size transformation consisting of mobilization of funds, and their allocation by providing large loans on the basis of numerous small deposits.
7. Maturity : • Maturity transformation by offering the savers tailor-made short term claims or liquid deposits and so offering borrowers long term loans matching the cash flows generated by their investment.

Role and Importance of Indian Financial System

The economic development of any country depends upon the existence of a well-organized financial system. It is the financial system which supplies the necessary financial inputs for the production of goods and services which in turn promote the well-being and standard of living of the people of a country. Thus, the 'financial system' is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. The responsibility of the financial system is to mobilize the savings in the form of money and monetary assets and invest them to productive ventures. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Thus, the financial system provides the intermediation between savers and investors and promotes faster economic development. Therefore it is essential to study about role of Indian financial system in economic development of a country.

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. The financial system mobilizes the savings of the people by offering appropriate incentives and by deepening and widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system, all savings would remain idle in the hands of the savers and they would not have flown into productive ventures. • For the economic growth of any nation, investment is absolutely essential. This, investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods and services and incomes in the country. The financial system collects the savings and channels them into investment which contributes positively towards economic development.
2. Encouraging Investments in Financial Assets :The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money and monetary assets) as against physical assets (land, gold and other goods and services). • The investments in physical assets are speculative and would breed inflation. On the other hand investments in financial assets are non-inflationary in nature and would aid growth in the economy. The larger the proportion of the financial assets, the greater is the scope for economic growth in the long run.
3. 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.
4. 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.

5. 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.

6. 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.

7. 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

8. Employment Growth is Boosted : 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. Moreover, the financial institutions encourage the managerial and entrepreneurial talents in the economy by promoting the spirit of enterprise and risk taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

9. 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.

10. 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.

11. 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.
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. 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.
14. Providing a Spectrum of Financial Assets: The financial system provides a spectrum of financial assets so as to meet the varied requirements and preferences of household. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity and risk. Thus, it contributes to the economic development of a country.
15. Developing Backward Areas: The integral policy of the national development plans of every country concentrates on the development of relatively less developed areas called backward areas. The financial institutions provide a package of services, infrastructure and incentives conducive to a healthy growth of industries in such backward areas and thus they contribute for the uniform development of all regions in a country.

Conclusion:
Thus the financial system is of crucial significance overall development of country. The financial system is important for capital formation. The adequate capital formation is indispensable to a speedy economic development is universally recognized. The main function of financial system is the collection of saving and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. Moreover, 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. However, certain refinements are needed to bring the Indian markets on par with the major international markets.

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