Role of Financial System in Economic Development of India

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1. Introduction

The Financial System plays a significant role in the process of Economic Development of a Country. The Financial System comprises of a network of Commercial Banks, Non-Banking Companies, Development Banks and other financial and investment institutions offer a variety of Financial Products and Services to suit to the varied requirement of different categories of people. Since they function in a Developed Capital and Money Markets, they play a crucial role in spurring economic growth in the following ways:

- Mobilizing Savings.
- Promoting Investments
- Encouraging Investment in Financial Assets
- Allocating Savings on the Basis of National Priorities
- Creating Credit
- Providing a Spectrum of Financial Assets
- Financing Trade, Industry and Agriculture
- Encouraging Entrepreneurial Talents
- Providing Financial Services
- Developing Backward Areas
- **Mobilizing 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.
- **Promoting Investments:** For the Economic Growth of any Nation, investment is 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.
- **Encouraging Investment 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).
- **Allocating Savings on the Basis of National Priorities:** The Financial System Allocates the Savings in a more efficient manner so that the scarce capital may be more efficiently utilized among the various alternative investments. In other words, it gives preference to certain sectors, from the social and economic point of view, on the basis of national priorities.
- **Creating Credit:** Large Financial Resources are needed for the Economic Development of a nation. These resources are supplied by the Financial System not only in the form of liquid cash but also in the form of ‘Created Money’ or ‘Deposit Money’ by creating credit and thereby making available large resources to Finance Trade, Production, Distribution etc.
- **Providing a Spectrum of Financial Assets:** The Financial System provides a spectrum of Financial Assets to meet the varied requirements and preference of house hole. Thus, it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of Return, Liquidity and Risk.
- **Financing Trade, Industry and Agriculture:** All the Financial Institutions operating in a Financial System take all efforts to ensure that no worthwhile project- is it in trade or agriculture or industry-suffers due to lack of funds. Thus, they promote industrial and agricultural development, which has a greater say on the Economic Development of a Country.
- **Providing Financial Services**: Innovations have started appearing in the arena of Financial Intermediations as well. The Financial Institutions play a very dynamic role in the economic development of a country not only as a provider of finance, but also as a departmental store of finance by offering varieties of innovative financial products and services to meet the ever increasing demands of their clients both corporate and individuals.
- **Encouraging Entrepreneurial Talents:** The Financial Institutions encourage the Managerial and Entrepreneurial Talents in the economy by promoting the spirit of Enterprise and Risk Taking Capacity.

- **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.

2. Money Market

- The Money Market is where Financial Instruments with high liquidity and very short term maturities are traded.
- The Money Market is market for Financial Assets that are close substitutes for money.
- It is a market for Short Term Funds and instruments having a maturity period of one or less than one year.

Characteristics of Money Market

The following are the general Features / Characteristics of a Money Market:

- It is market purely for Short-Term Funds or Financial Assets called Near Money.
- It deals with Financial Assets having a maturity period up to one year only.
- It deals with only those assets which can be converted into cash readily without loss and with Minimum Transaction Cost.
- Generally transactions take place through phone i.e. ., Oral Communication.
- Transactions have to be conducted without the help of brokers.
- The Central Bank and commercial banks are the major institutions in the Money Market.
- This market supplies funds for financing current business operations, Working Capital requirements of industries and short period requirements of the Government.

Functions of Money Market

- By providing various kinds of credit instruments suitable and attractive for different sections.
- A Money Market helps to avoid wide seasonal fluctuation in the interest rates.
- A Money Market, by augmenting the supply of funds and making of them readily available to the legitimate borrowers, helps in the making funds available at cheaper rates.
- A well organized Money Market, through Quick Transfer of funds from one place to another.
- It enhances the amount of liquidity available to the entire country.
- A Money Market, by providing Profitable Investment Opportunities for Short-Term Surplus funds, helps to enhance the profit of financial institutions and individual.

Importance of Money Market

- Developed Money Market plays an important role in the Financial System of a country by supplying short, terms funds adequately and quickly to trade and industry. Money Market is an integral part of a country economy.
- Development of Economy.
- Development of source Capital Market.
- Smooth Functioning of Commercial Banks.
- Effective Central Bank Control and helps to government.
- Formulation of suitable Monetary Policy.

Classification of Money Market

Money Market may be further divided into

- Call/Notice Money Market
- Commercial Bill Market /Bill of Exchange
- Treasury Bill Market

- **Call/Notice Money Market:** The Call Money Market (CMM) is the market where overnight (one day) loans can be availed by banks to meet liquidity. The Call Money Market is a market for very short-term funds repayable and with a maturity period varying between one day to for tnight.
- **Commercial Bill Market / Bill of Exchange:** The Commercial Bills are issued by the seller (Drawer) on the buyer (Drawee) for the value of goods delivered by him. These bills are of 30 days, 60 days, 90 days maturity. If seller is need funds, he may draw a bill and send it to the buyer for acceptance. The buyer accepts the bill and promise to make payment on the due date. He may also approach his bank to accept the bill. The bank charges a commission for the acceptance of bill and promise to make the payment if the buyer defaults.
- **Treasury Bill Market:** Treasury Bills also known as T- Bills. T- Bills are the Short Term Money Market Instrument, issued by the Central Bank on behalf of the government to meet the Short Term Liquidity. They don’t yield any interest, but issued at discount, at its redemption price and repaid at par when it gets matured.

Capital Market

- Capital Market is a market where buyers and sellers engage in trade of Financial Securities like Bonds, Stocks .etc.
- The Buying and selling is undertaken by participants such as individuals and institutions.

Participants: There are many players in the Capital Market. The participants in the Capital Market include the flowing:

- Brokers
- Venture Capital Funds
- Mutual Funds
- Share Transfer Agents
- Depositors

Functions of Capital Market

The functions performed by the Capital Market are detailed below;

Allocation Function: The market attracts new investors who are willing to make new funds available to business. It also allocates and rations funds by a system of incentives and penalties.

Liquidity Function: Capital Market provides a means whereby buyers and sellers can exchange securities at mutually satisfactory prices. This allows better liquidity for the securities that are traded.

Other Functions: In additional to the functions of funds allocation and liquidity, capital market also renders the following functions:

- Indicative Function
- Savings and Investments Function
- Transfer Function
- Merger Function

Importance of Capital Market

The importance of Capital Market can be briefly summarized as follows

- The Capital Market serves as an important source for the productive use of the economy‘s savings.
- It provides incentives to savings and facilitates capital formation by offering suitable rates of interest as the price of capital.
- It provides an avenue for investors, particularly the households sector to invest in financial assets which are more productive than physical assets.
- The operations of different institutions in the capital market induce economic growth.
- A healthy Capital Market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

Classification of Capital Markets

1. Capital Market may be further divided into three

- Primary Market
- Secondary Market
- Derivative Market

- **Primary Market:** The Primary Market is also called as New Issue Market (NIM). NIM is where new securities are issued. The market where new securities are issued and sold directly by issuer to investor.
- **Secondary Market:** The Secondary Market is where investors buy and sell securities they already own. Ex: NSE, BSE.
- **Derivative Market:** The Derivative Market is the Financial Market for Derivatives. A derivative is a contract between two parties which derives its value from and underlying assets. The most common type of derivatives is Futures, Forwards, Options, and Swaps.

3. Financial Service Sector Problems & Reforms

However, the Financial Service Sector has to face many challenges in its attempted to fulfill the ever growing Financial Demands of the Economy. 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 innovation Financial Instruments have been introduced. Besides, there has been a mushroom 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 weakness as listed below

Lack of Qualified Personnel: The Financial Services Sector is fully geared to the task of 'Financial Creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence it is very vital that a proper and a comprehensive training must be given to the various Financial Intermediaries.

- **Lack of Transparency:** The Financial System is undergoing a phenomenal change in accordance with the requirement of the national and global environments. It is high time that this sector gave up their standard attitude of keeping accounts in a highly secret manner.
- **Lack of Specialization:** In the Indian scene, each financial intermediary seems to deal in Different Financial Service Lines without specializing in one or two areas.
- **Lack of Investor Awareness:** The introduction of New Financial Products and Instruments will be of no use unless the investor is aware of the advantages and uses of the new innovative products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through Literature, Seminars, Workshops, and Advertisements and even through Audio-Visual Aids.
- **Lack of Recent Data:** Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper database in the basis of which one could go aboard upon "Financial Creativity".
- **Lack of Co-ordination between different Financial Institutions:** There are a large number of financial intermediaries. The Government owns most of the vital financial institutions. At the same time, the Government is also 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.
- **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.

4. Conclusion

Financial System plays a significant role in the process of Economic Development of a Country. Hence, the Indian Financial System is more developed and integrated today. Even though, India is facing problems in this Financial Sector in some areas. To overcome the difficulties, the Government of India assigned monitoring and regulating the Financial Sector with the Agencies that are involved in the regulation of the financial services activities. In India , agencies such as the Securities Exchange Board of India (SEBI), Reserve Bank of India(RBI) and the Department of Banking and Insurance, Insurance Regulatory and Development Authority of India(IRDAI) Government of India, through a plethora of legislative measures.

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