BLOCK I:
FINANCIAL SYSTEM

Unit 1 : Concept and Functions of a Financial System

Unit 2 : Component of Financial system- Financial Markets, Financial Instruments, Financial Institutions and Financial Services

Unit 3 : Financial Development and Economic Development, Flow of Funds Accounts, Indicators of Financial Development

Unit 4 : Reforms in the Indian Financial System

Unit-1

Concept and Functions of a Financial System

Unit Structure:

1.1 Introduction
1.2 Objectives
1.3 Concept of Financial System
1.4 Nature of Financial System
1.5 Functions of Financial System
1.6 Structure of Indian Financial System
1.7 Summing Up
1.8 Model Questions
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1.1 Introduction

It has been rightly said that level of the economic development of a country depends upon the level of the development of its financial system. The Indian Financial system is quite old with rich and varied evolutionary experience. An efficient financial system is an indicator of a robust economy. Financial system is an institutional arrangement comprised of financial institution, financial markets, instruments and financial services. It is a system where the various constituents are inter-related and they work together. Financial system performs the functions of mobilizing the savings and channelizing the same into the productive channels. The various constituents of the financial system are again sub divided into various parts. Financial market is sub-divided as money market and capital market, which is further divided into primary market and secondary market. Financial institutions are divided as banking and non banking institutions. Financial instruments are classified as short term, medium term and long term assets and financial services are classified as fund based and non fund based services.

1.2 Objectives

After going through this unit you will be able to–

- define the concept of financial system,

- describe the functions of financial system,
- depict the structure of Indian financial system.

1.3 Concept of Financial System

Financial system is comprised of two words- Finance and system. So in order to understand the term of financial system we should first understand the term- finance and system. The term finance is related to monetary resource which is comprised of ownership of funds and debts. System is a set of inter related parts working together to achieve some purpose. Say for example, the human body. (the most complex system in the world) where the various parts are inter-related with each other. Thus, Financial system is a set of complex and closely connected or inter-mixed financial institutions, market agents, instruments, services, practices, products, transactions, claims, and liabilities and so on in an economy. It is also referred as a set of institutional arrangements through which financial surplus of our economy is mobilized from surplus units and transferred to deficit units. A financial system consists of savers, intermediaries, markets and investors and is mostly concerned about money, credit and finance.

Stop to Consider.

Difference between Financial system and payment system

Financial system is a broader concept as compared to payment system. Financial system is concerned about cash and credit transaction whereas; payment system is concerned only with cash payment transaction.

1.4 Nature of Financial System

Different natures of financial system are discussed under the following points:

i) Financial system is a Sub-system: A Financial system forms a part of the overall economic environment. Financial system is a sub-system of the overall economic environment. The economic environment influences the financial system. The latter, in turn impacts the firm's the investing and financial decisions.

ii) **Elements:** The financial system consists of basically four elements viz. financial assets or instrument, financial markets, financial institutions and financial services.

iii) **Mechanism:** Financial system provides means and mechanism of transferring resources from those who have an excess income over expenditure to those who can make productive use of the same.

iv) **Formal and informal financial sector:** The co-existence of both formal and informal financial sector is another important nature of a financial system. This co-existence of two sectors is known as 'financial dualism'. Formal financial sector is well organized and regulated, where as the informal financial sector is unorganized, non-institutional and non-regulated.

v) **Accelerating savings:** Besides mobilizing savings the financial system helps accelerate the volume and rate of savings by providing diversified range of financial instruments and services through intermediaries.

1.5 Functions of Financial System

The financial system tries to improve the allocation efficiency in the economy and in the process helps cost of resources as interest rates are the very strong indicators of the strength of an economy as well as the financial system. The functions of financial system are discussed under the following points-

i) **Financial institution acts as intermediary:** One of the basic functions of financial institution is to act as an intermediary between the savers and investors. It helps in mobilizing the surplus fund from the economy and channelizes it into productive sector of the economy. Thus, the financial system functions as a link between the savers and investors.

ii) **Capital Formation:** Financial system mobilizes the savings from the surplus sector with the help of various financial intermediaries and instruments. This leads to capital formation which is very important for the development of any economy.

iii) **Provide payment and settlement system:** A good financial system provides a payment mechanism for the exchange of goods and services and transfers economic resource through time and

across geographical regions. It also provides industrial payment and settlement system which play an important role to ensure that funds move safely, quickly and in a timely manner.

iv) **Transfer of financial resources:** Financial system provides a mechanism for special and temporal transfer of resources. It facilitates transfer of financial resources across time and geographical boundaries.

v) **Controlling risk and uncertainty:** Financial system provides a way of managing and controlling uncertainty and risk. There are basically three means of controlling risk and uncertainly. These are-

- Diversification of risk: Every investment is associated with certain degree of risk. The financial system helps to diversify such risk by offering various avenues of investment. Accordingly the investors can diversify their investment and minimize the risk associated with the overall investment.
- Insurance: One of the important means of controlling risk and uncertainty is insurance. It is the process of transferring risk associated with the life and property to the insurance companies on payment of certain consideration.
- Hedging: Hedging refers to a risk management strategy that is meant to protect future prices or to limit losses. It involves buying and selling investments to reduce the risk of losing an existing position

vi) **Provides price related information:** A good financial system also makes price related information available which is a valuable assistance to those who need to take economic and financial decisions. By doing so, it reduces the cost of gathering and analyzing information.

vii) **Offers Portfolio adjustment facility:** A financial system offers portfolio adjustment facilities. This is done of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets through financial markets and financial intermediaries such as banks etc.

viii) **Lowers the cost of transaction:** A financial system helps in lowering the cost of transaction by creating a financial structure. As the cost of transaction is reduced, the savers get higher rate of return.

ix) **Promote the process of financial deepening and broadening:** Financial deepening refers to an increase of financial assets as a percentage of Gross Domestic Product (GDP). Financial Broadening refers to building an increasing number and variety of participants and instruments. A financial system helps in promoting the process of financial deepening and broadening.

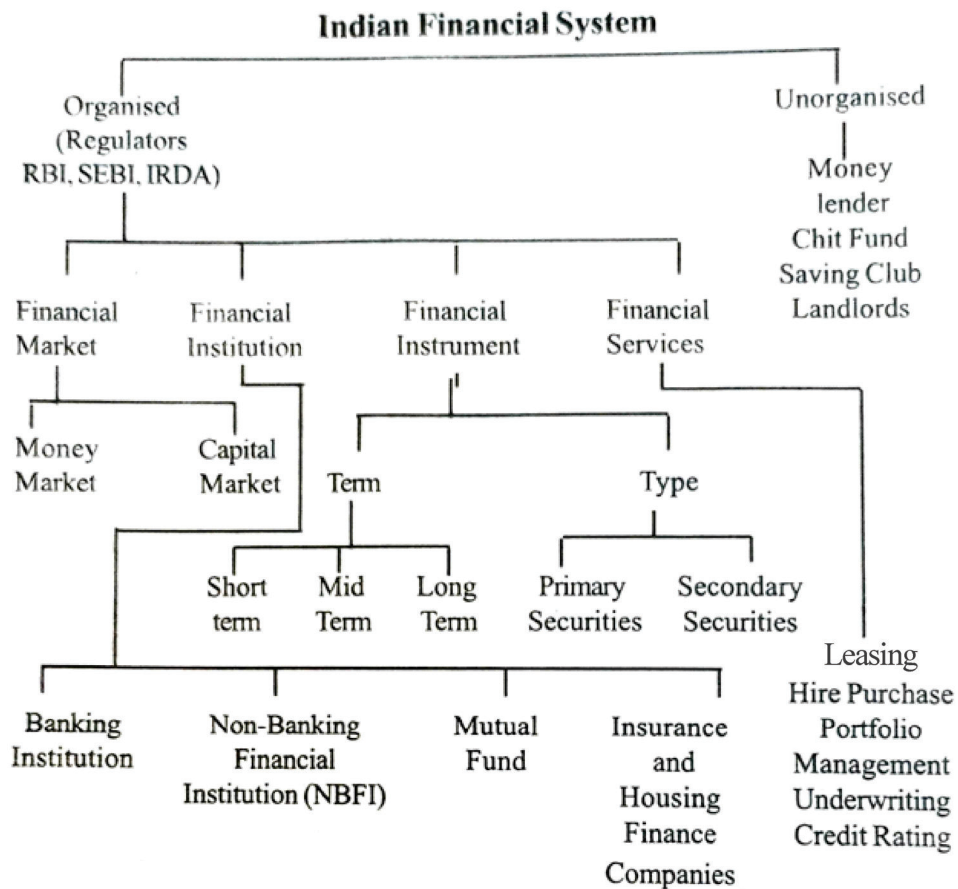
Check Your Progress

1. Fill up the blanks
   i) Financial institution act as intermediaries in between _______ and investors.
   ii) One of the important functions of financial system is _______ formation.
2. Name three means of controlling risk provided by the financial system?
3. Write five nature of financial system
4. Mention any five functions of financial system.

1.6 Structure of Indian Financial System

Structure is a framework or pattern or design, which is made by its different components as parts. Financial system can be broadly classified into two categories- Organised and unorganized. The organized part of the financial system consists of four components namely : Financial markets, Financial Institutions, Financial Instruments and Financial services. The organised financial system comes under the regulation of the Reserve Bank of India (RBI) the Securities and Exchange Board of India (SEBI) and other regulatory bodies. The unorganized financial system consists of money lenders, landlords, Saving Club, fixed fund, etc. The regulatory bodies have not been able to bring this sector under their complete purview even after the 75th year of independence.

Let us try to understand the structure and component of Indian Financial System with the help of the following chart.



A. Formal Organized Sector: Organized sector of Indian financial system is under controlled of the different regulatory bodies, such as the Reserve Bank of India, the Government of India, Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA) etc..

i) Financial Institution: Financial Institutions or intermediaries are firms that provide products and service in the financial markets for the benefits of customers, individuals and firms. They help in pooling resource from individuals and firms and promote making best use of these financial resources. They borrow fund (or accept) from those who are willing to give up their current purchasing power and lend to (or buy securities from) those who require the funds for meeting the current expenditures. Different types of Banks, Non banking financial institutions, mutual funds, insurance and housing finance companies are the main intermediaries of the financial system.

ii) Financial Instruments and Assets: Financial instrument is defined as real or virtual document representing a claim against a person or an institution

for payment, at a future date, of a sum of money and or a periodic payment in the form of interest or dividend. Financial instruments may be divided into two types: cash instruments and derivative instruments. Those asset which performs some function of money and have high degree of liquidity (but not as liquid as money) are called financial instrument or asset. Share, stock, bonds, bank deposit, LIC policy etc. are some of the example of financial asset. Financial assets may be classified on the basis of terms such as midterm, short term and long term asset. Financial asset are also classified as primary or direct and secondary or indirect assets.

iii) Financial Market: Financial market is a link between the savers and borrowers. This market transfers the money or the capital from those who have surplus money to those who are in need of investment. The investors are called surplus units and business enterprises are called deficit units. So, financial market transfers money supply from surplus to deficit units. Financial markets are basically a mechanism which facilitates the participants to deal in financial claims. Financial market is broadly a market place where creation, introduction and exchange and trading of long term and short term financial instruments takes place. The financial market also provides a facility in which their demands and requirements interact to set a price for such claims. In India the organized financial markets are (a) Money Market (b) Capital Market.

Money market is the financial market which deals in short term securities. It involves the buying and selling of large volumes of very short term debt product which is less than one year. It is basically used by Government and corporations to keep their cash flow steady, and for investors to make a desirable profit.

Capital market is a financial market which deals in long term securities that is securities having maturity period of one year or more than a year. Capital market brings buyers and sellers together to trade stocks, bonds, currencies and other financial assets. Capital market mobilizes savings, helping in raising long term capital and also helps in revival of sick units.

Further the capital market can also be classified as Primary market and Secondary market. Primary market is generally the part of capital market where companies deals with issuance and sale of securities to investors directly by the issuer, with the issuer being paid the proceeds. An example of a primary market transaction is an initial public offering. In an IPO, a company sells its shares directly to the public for the first time.

Secondary market is the market where previously issued financial instruments, such as bonds, stocks and derivatives are bought and sold by investors. In secondary market the actual trade takes place between other investors and traders rather than from the companies that issues securities. There are two components of the secondary market, over the counter (OTC) market and the exchange traded market. In an OTC market, spot traders are negotiated and traded for immediate delivery and payment while in the exchange traded market, trading takes place over a trading cycle in stock exchanges.

iv) Financial Services: Financial Service is a broad range of offerings within the finance industry which includes insurance, money management and digital banking technology. Merchant banking, Portfolio management, industrial consultancy, broking, Hire-purchase, consumer financing and real estate finance etc are some of the examples of Financial Services. Financial Services are broadly classified into two categories:

(i) Non-Fund based service: In this type of financial service, the service provider has no financial involvement rather they provide service such as portfolio management, consultancy service, stock broking service in exchange of some fees or commission.

(ii) Fund based service: In this type of financial service, fund of the service provider is involved. Consumer loan, hire purchase, real estate finance etc are example of Fund based financial service.

B. Informal or Unorganized Sector: Informal or unorganized financial system covers moneylenders, local bankers, traders, landlord, pawa, broke etc.These are not under the regulation of Reserve Bank of India and Securities and Exchange Board of India. Money lenders entirely depend on their own funds for the working capital. Merchants, traders, artisans, goldsmiths, village shopkeepers, sardars of labourers etc. are examples of money lenders. Money lenders may be classified as rural money lenders, urban money lenders, and professional money lenders. Generally financially weaker sections of the society are the clients of money lenders. The loans granted by money lenders are highly exploitative as because they charge very high rates of interest. The operations of money lenders are wholly unregulated. From ancient times indigenous banking system has been in existence in India.

Check Your Progress
1. Name four elements of a financial system? 2. Name four regulatory bodies which control organized sector of Indian financial system. 3. Name two types of financial market. 4. Name two types of Capital market.

1.7 Summing Up

1. A financial system is a complex, well integrated set of sub-system of financial institutions, markets, instruments and serving which facilitates the transfer and allocation of funds efficiently and effectively.
2. Nature of financial system-
   a. Financial system forms part of the overall economic environment.
   b. Financial system consist financial instrument, financial markets financial institutions and financial services.
   c. Elements of financial system are closely interrelated and do change continuously.
   d. Financial system facilitates growth and economic development through savings and investment.
   e. Co-existence and co-operation between formal and informal financial sector is an important feature of financial system of most developing country.
3. Functions of financial system:
   i. Helps the flow of funds form surplus sector to the deficit sector
   ii. Act as an intermediary
   iii. Channelize funds
   iv. Payment system
   v. Transfer of financial resources
   vi. Controlling risks and uncertainly
   vii. Generate information

viii. Financial structure

ix. Monitor corporate performance

x. Portfolio adjustment

xi. Financial deepening and borrowing

4. Structure of Indian Financial System: Structure of Indian financial system is made with both formal and informal sector. Formal sector is controlled by RBI, Govt. of India, SEBI and IRDA. Informal sector covers money lenders, local bankers, prodders, land lord, pawn broker etc.

1.8 Model Questions

1. What is Financial System?
2. Explain the various nature of financial system?
3. What are the components/elements of Financial System?
4. Describe the various functions of Financial System?
5. Describe the structure of Indian Financial system?

1.9 References and Suggested Readings

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Unit-2

Component of Financial System- Financial Markets, Financial Instruments, Financial Institutions and Financial Services

Unit Structure:

2.1 Introduction
2.2 Objectives
2.3 Financial Market
2.4 Functions of Financial Market
2.5 Financial Instruments
2.6 Financial Institutions
2.7 Financial Services
2.8 Summing Up
2.9 Model Questions
2.10 References and Suggested Readings

2.1 Introduction

A financial system plays a key role in the economic growth and development of a country. Financial system enables the flow of funds between savers and borrowers, which tends to result promotion of economic growth and development of a country. There are four main components of financial system a) Financial Market (b) Financial Institution (c) Financial Instruments (d) Financial Service. Financial Market includes any place or system that facilitates the buyers and sellers the means to buy and sell financial instruments which include bonds, equities, various international currencies, and derivatives. Financial instrument include any type of financial asset that can be traded by investors, whether it is tangible asset like physical asset or a debt contract. Most financial instruments are marketable as they are denominated in small amounts and traded in organized markets. A financial institution is a business entity that provides services such as accepting deposits, lending, and investment products to individuals, businesses, or both. The major categories of financial institution are central bank, retail bank, commercial bank, insurance company, Mortgage Company etc. Financial institutions are intermediaries that mobilize savings and facilitate

the allocation of funds in an efficient manner. Financial services are the services which are offered by the financial companies. Financial services are a broad range of more specific activities such as banking, investing and insurance. The major categories of financial services are fund intermediation, payment mechanism, provision of liquidity, risk management and financial engineering.

2.2 Objectives

After going through this unit, you will be able–

- to identify the various components of financial system,
- to understand the various components of the financial system.

2.3 Financial Market – its Types and Functions

Financial markets are credit markets which cater to the credit needs of individuals, firms and institutions. Since credit is required and supplied for short period and long period, the financial markets are broadly divided into two types:

(a) Money Market;

(b) Capital Market.

(a) Money Market: Money market deals with the short period borrowing and lending of funds. In the money market, the short term securities are exchanged. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months and against different types of instruments, such as bill of exchange, bankers' acceptances, bonds etc. called 'near money'.

(b) Capital Market: Capital market deals with the long period borrowing of funds. In the capital market, long term securities are exchanged. Capital market can again be categorised into: (a) primary market and (b) secondary market. Primary market is a market in which newly issued credit instruments are sold and purchased. Secondary market, on the other hand, is a market in which previously issued credit instruments are bought and sold.

2.4 Functions of Financial Market

The important functions of the financial markets can be summed up in the following way:

(1) They create and allocate credit.

(2) They serve as intermediaries in the process of mobilisation of saving.

(3) They provide convenience of benefits to lenders as well as borrowers.

(4) They enable economic units to exercise their time preference.

(5) They help in the separation, distribution, diversification and reduction of risk.

(6) They provide transformation of financial claims so as to suit the preference of both savers and borrowers.

(7) They provide efficient payment mechanism.

(8) They increase liquidity of financial claims through securities trading.

(9) They provide better portfolio management.

(10) They promote economic development through a balanced regional and sectoral allocation of investable funds.

Check Your Progress

1. What is Financial Market?
2. What are the main functions of Financial Market?
3. Mention two types of Financial Market.
4. What is Money Market?
5. What is Capital Market?

Stop to Consider

Financial markets are credit markets which cater to the credit needs of individuals, firms and institutions. Financial markets can broadly be categorised into two: i.e. money market and capital market. Money market deals with the short term period borrowing and lending of funds and Capital market deals with the long term period borrowing of funds. Financial market serves as intermediaries in the process of mobilisation of savings.

2.5 Financial Instruments

Financial instrument is defined as real or virtual document representing a claim against a person or an institution for payment, at a future date, of a sum of money and or a periodic payment in the form of interest or dividend. Financial instruments may be divided into two types: cash instruments and derivative instruments. Those asset which performs some function of money and have high degree of liquidity (but not as liquid as money) are called financial instrument or asset. Share, stock, bonds, bank deposit, LIC policy etc. are some of the example of financial asset. Financial assets may be classified on the basis of terms such as mid-term, short term and long term asset. Financial asset are also classified as primary or direct and secondary or indirect assets.

Types of financial instruments:

a) Equity instruments: Equity based instruments are basically the stocks which are shares of a company implying the ownership of an asset. When a stock is purchased then we are normally buying a piece of company. There are two types of stocks (a) common stocks (b) preferred stocks. A common stock holder poses the right to vote on a matter related to company such as electing of directors etc. However, in the event of liquidation, they are the last receivers. On the other hand preferred stock holders do not poses the right to vote. Although they receive dividends prior to common stockholders and have a priority claims on assets if the company goes under liquidation.

b) Debt instruments: Debt instruments traded on the stock exchange can be classified into bonds and debentures. These are essentially loans made by an investor to the owner of the asset. Short term debt based financial instruments last for one year or less for e.g. Treasury Bills and Commercial papers, Bank Deposit. Long term debt securities are typically issued as bonds or mortgage backed securities. Types of bonds are Govt. Bonds, Corporate Bonds and Municipal Bonds.

c) Derivatives: Derivatives are financial contracts whose value is tied to performance of an underlying asset, like stocks, bonds or commodities. Different types of derivatives are options, futures, and swaps.

d) Money market instruments: There are variety of instruments that trade in the money market in both the stock exchanges i.e. NSE and BSE. These include treasury bills, certificates of deposits, commercial paper, repurchase agreements.

e) Mutual funds: Mutual fund is pool of money, collected from the interested investor that is to be invested according to certain specific investment objectives of investors. Mutual fund is a pool of investor's funds where investors put their money together. There are four main types of mutual funds they are a) Money market funds b) Bond funds c) Stock funds d) Target funds. Each type has different features, risks and rewards.

f) Foreign Exchange (Forex) instruments: Foreign exchange instruments are financial instruments that are represented on the foreign market and primarily consist of currency agreements and derivatives.

Features of financial instruments:

1) Financial instruments help financial markets and financial intermediaries to perform the important role of channelizing funds from lenders to borrowers.

2) Financial instruments facilitate interested parties to trade in currencies where interested parties are provided opportunities to generate profit from currency fluctuations.

3) Financial instrument are basically tradable assets of any kind which can be cash, evidence of ownership interest in entity, or a contractual right to receive or deliver cash or another financial instrument.

4) Financial instruments differ in terms of marketability, liquidity, reversibility, type of options, return, risk and transaction costs.

5) Financial instruments are marketable as they are denominated in small amounts and traded in organized markets which facilitate people to hold a portfolio of different financial assets which , in turn, helps in reducing risk

2.6 Financial Institutions

Financial institutions are normal banking or non-banking financial institutions which act as intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner. Financial institutions are the organization that provides financial services for its clients, members and society. The key role played by financial institution is acting as financial intermediaries. Financial institutions accept and manage deposits and advance loans to those needy. Financial institutions can also act as insurance companies, pension funds investment institutions, underwriters, brokerage firms, investment banks. Financial institution can be categorized as banking and non banking financial institutions. Banking financial institutions are creator of liquidity and its basic function is to manage risk. The four main types of risks are credit risk, interest rate risk, liquidity risk and operational risk. The banking financial institution basically deals with finance and monetary transactions such as accepting of deposits, granting of loans, investments and exchange of currency. On the other hand, Non-banking financial institutions (NBFI) are entities that are not banking organization yet it provide bank like financial services. NBFI helps in the growth and development of economy. It helps to promote financial inclusion by encouraging investment and savings, improves the efficiency of investment and savings and also broadens the spectrum of risks available to investors.

Types of financial institution:

A) Banking financial institution.

B) Non banking financial institution.

A) Banking financial institution: Banking financial institutions are the financial institutions that provide various banking facilities such as accepting of deposits and granting of loans and advances to corporations and large business organization. It mobilizes the savings and facilitates the allocation of funds to deficit segment. Banking financial institution creates liquidity and creditability and its basic function is to manage risk. In a broad sense banking financial institution deals with finance and monetary transactions such as accepting of deposits, granting of loans, investments and exchange of currency.

Types of Banking Financial Institution:

a) Commercial Banks: A commercial bank is a financial institution which provides basic banking services such as accepting of deposits from

general public, corporate and granting of loans and advances for investment to deficit sector for investment with the ultimate aim of generating profit. The State Bank of India is one of the largest commercial banks in India. Commercial banks include scheduled, non-scheduled and Indian, foreign commercial banks.

b) Central Bank: A central bank is an apex institution, which operates, control, directs and regulates the monetary and banking structure of a country. A central bank is a bank is any country to which has been entrusted the duty of regulating the volume of currency and credit in that country. Example: Reserve Bank of India is the central bank of India.

c) Foreign Banks: Foreign banks are those banks which are originated from a different country and provide services in other countries. It follows the rules and regulations of both the home and host countries. It plays a vital role in shaping the attitude and policies of foreign Government, Companies and their clients towards India

d) Regional Rural Banks (RRB): RRB is Indian scheduled commercial banks of India that operates at regional level in different states.

e) Investment Banks: Investment banks are banking financial institution which act as intermediaries that acquire the savings of people and allocates these funds into the business units seeking capital for the purpose of business extension or to meet the capital shortage. Basic function of Investment Bank is formation of capital, underwritings, acting as dealer.

f) Cooperative Banks: A cooperatives bank is a financial institution started by a group of individuals who are at the same time owners and the customers of their bank in order to address the capital needs of their specific community.

B) Non Banking Financial Institution: Non Banking Financial Institution are business entities that are not banking organization still it provides bank like financial services to interested parties. A non banking financial institution do not hold any banking license and cannot accept deposits from public or grant loan or advances to public. It acts as an intermediary between traditional banks and customers where the reach of traditional banks is limited. The main motive of non banking financial institution is to meet the financial needs for individuals which were not sufficiently met by the existing

banking system offering such a wide range of financial products and services. NBFI provides attractive features and benefits for both new and existing borrowers. NBFI provides better customer service by facilitating flexible terms and conditions.

Types of Non Banking Financial Institution:

a) Leasing Company: Leasing companies are the companies that are engaged in financing the purchase of concrete assets.

b) Loan Company: Loan companies are financial institutions whose main motive is to provide finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

c) Investment Company: Investment Company is a financial institution whose principal business is holding, managing and investing securities.

d) Hire Purchase Company: Hire purchase Company is a non banking finance company whose principal business is to deal in the business of hire purchase transactions or financing of such transactions.

e) Chit fund: Chit fund companies carries out chit fund business as their principal business.

f) Asset Finance Company(AFC): An Asset Finance Company is a financial institution whose principal business is to financing of physical assets, and supports economic or productive activity, such as automobiles, tractors, generator sets, earth moving, moving on own power and general purpose industrial machines.

g) Insurance company: Insurance company are the financial intermediaries between insurer (insurance company) and an insured where the insurer offer direct insurance or reinsurance services to the insured in an insured is provided is provided financial protection from an insured for the loses he/she may suffer under specific circumstances. Insurance company are banking financial institution the creates insurance products to take on risks in return for the payment of premiums.

Features of financial institution:

1) Financial institution accepts deposits from the public and provides funds to the needy segments for start ups in the form of loans and advances with the intention to earn profit.
2) Financial institution underwrites new issue of shares and debentures.
3) Financial institution includes both banking and non banking financial institutions.
4) Financial institutions provide technical, managerial and administrative assistance to industrial concerns.
5) Financial institution also advances loans in foreign currency towards the cost of imported capital equipment.
6) Financial institution extends guarantee for deferred payments.
7) Financial institution provides financial assistance not only to private sector but also to the public sector undertakings etc.

Stop to Consider:

- Non-banking financial institutions do not take deposits from customers. Instead, they raise money by selling securities or borrowing money.
- Non-banking financial institutions are not required to maintain a reserve ratio like banks are. This ratio is the percentage of deposits that a bank must keep in reserve in case of withdrawals.

2.7 Financial Services

Financial services can be defined as the activities/facilities that are financial in nature provided by financial institutions such as borrowing and funding, lending and investing, buying and selling of securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The major categories of financial services are fund intermediation, payments mechanism, provision of liquidity, risk management, and financial engineering.

Types of financial services:

a) Fund based services

b) Fee based services

a) ***Fund based services***: In this type of financial service, fund of the service provider is involved. The provider of such service makes financial engagements and in return they charge interest on the amount of fund engaged from the customer who avails such service. Consumer loan, hire purchase, real estate finance etc are example of Fund based financial service.

1) Leasing: Leasing is a contractual arrangement where assets are provided to clients for using it over a specified period in return for periodic lease payments. Eg: Companies leasing vehicle or equipment from financial institutions.

2) Hire Purchase: Hire purchase is an arrangement for purchasing expensive assets/goods, where the purchaser makes an initial down payment for acquiring the asset and pays the balance amount in consequtive installment with interest. Eg: Purchasing a car with an initial down payment is an example of hire purchase.

3) Insurance: Insurance is a contract between two parties that is insurer and the insured, insurer is the insurance company who assures to provide financial protection to the insured in case of any loss suffered by the insured under any circumstances which is clearly mentioned in the contact whereas insured is the party/ individual to whom the financial protection is provided according to the legal agreement. Eg: Life Insurance, Health Insurance, Home Insurance.

4) Bill Discounting: Bill discounting refers to a fee charged by the bank from the seller of the goods to release funds before the end of the credit period. The bill is presented to the customer and amount is collected by the bank. It is mostly applicable in cases where letter of credit is used as a mode of payment.

5) Consumer Credit: Consumer credit refers to the activities involved in arrangement of credit to consumers for purchasing of goods and services and pay for them in the future date. The consumer is entitled to avail credit to extent sanctioned as credit limit eg: Credit Card

6) Venture Capital: Venture capital is long term risk capital to finance high technology projects which involve risks but at the same time has strong potential for growth.

b) ***Fee Based Services***: In this type of financial service, the service provider has no financial involvement rather they provide service such as portfolio management, consultancy service, stock broking service in exchange of some fees or commission. Types of fee based financial services are:

a) Credit Rating: Credit rating is actually a financial service which evaluates the credit worthiness of a debtor, especially a business organization or a govt. by an approved body which rates the various debt securities of a company according to a set model. It is an evaluation made by a credit rating agency of the debtor's ability and willingness to payback the debt and likelihood of default.

b) Merchant Banking: Merchant Banking can be defined as the financial services provided by the merchant banks which covers a wide range of activities such as underwriting of shares, portfolio management, project counseling, insurance etc. They render all these services for a fee. Both commercial bank and investment banks may engage in merchant banking activities.

c) Loan Syndication: Loan syndication is a lending process in which a loan offered by a group of lenders who works together to provide funds for a single borrower. Borrower could be corporation, a large project, or sovereignty.

d) Project Counseling: Project counseling includes preparation of project reports, deciding upon the financial pattern, appraising the project relating to its technical, commercial and financial viability. It includes filling up of application forms for obtaining funds from financial institutions.

e) Depository Services: A depository is an organization where the securities of an investor are held in dematerialized form. Here the investors can keep their financial assets such as equities, bonds, mutual fund units etc in the electronic form and transactions could be effected on it. In India, there are two depositories namely, National Securities Depository Limited(NSDL) promoted primarily by IDBI, the Unit Trust of India and the National Stock Exchange. Central Depository promoted by the Stock Exchange, Mumbai.

Features of financial services:

a) Financial services are intangible in nature.

b) There are two types of financial services namely fund based financial services and fee based financial services.

c) Financial services are perishable in nature and cannot be stored.

d) It acts as link between the investor and borrower.

e) The responsibility of any financial services organization is to protect customer's interest and it is not only important in banking and insurance, but also in other sectors of the financial services.

f) Financial service act as financial intermediaries and are customer oriented.

g) Financial services are proactive in nature and help to visualize the expectations of the market.

Check Your Progress

1. What is financial Instrument? What are its different types?
2. State the meaning of Financial Institutions. Differentiate between Banking and Non Banking Financial Institution.
3. What is Financial Service? What are its different types? Give examples

2.8 Summing Up

1) A financial system plays a key role in the economic growth and development of a country. It enables the flow of funds between savers and borrowers, which tends to result promotion of economic growth and development of a country.

2) There are four main components of financial system a) Financial Market b) Financial Instrument c) Financial Institution d) Financial Service.

3) Financial market includes any place that facilitates the buyers and sellers the means to buy and sell financial instruments which include bonds, equities, the various international currencies and derivatives. It act as a link between savers and investors.

4) In India the main organized financial markets are a) Money Market b) Capital Market. Further the capital market can be classified as Primary and Secondary Market.

5) Financial instruments include any type of financial asset that can be traded by investors, whether it's a tangible entity like physical asset or debt contract. Most financial instruments are marketable as they are denominated in small amounts and traded in organized market.

6) Some of the types of financial instruments are a) Debt instruments b) Equity instrument c) Derivatives d) Money market instruments e) Mutual fund f) Foreign exchange (FOREX)

7) Financial institutions are normally banking or non banking financial institutions which act as intermediaries that mobilize savings and facilitate the allocation of funds in efficient manner. Financial institutions can also act as insurance company, pension funds investment institution, underwriters, brokerage firms.

8) There are two type of financial institution a) Banking financial institution b) Non banking financial institution. Banking financial institution is creator of liquidity and its basic function is to manage risk. NBFI's main motive is to meet the financial needs for individual which are not sufficiently met by existing banking system.

9) Financial service can be defined as the activities/facilities that are financial in nature provided by financial institutions such as borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets

10) There are two types of financial services a) Fund based services b) Fee based services. Fund based services are the financial services where banks provide short term and long term funds to individuals and businesses with intention to avail funds to the needy segment and also to earn interest on lent amount over a specified tenure. Whereas fee based services are the offerings of financial services in the form of advice or consultant for a fee.

2.9 Model Questions

1) What is financial system? What are the main components of financial system?

2) What is financial market? Explain the types of financial market?

3) State the salient features of financial market.

4) What are financial instruments? Briefly describe the types of financial instruments?

5) State the characteristics of financial instrument.

6) What are financial institutions? Elaborate the types of financial institution?

7) Explain the various types of banking and non banking financial institution?

8) State the characteristics of financial institutions.

9) What is financial service? What are the types of financial services?

10) Briefly explain the types of fund based and fee based financial services.

11) State the features of financial services.

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Unit–3

Financial Development and Economic Development, Flow of Funds Accounts, Indicators of Financial Development

Unit Structure:

3.1 Introduction

3.2 Objectives

3.3 Financial and Economic Development

3.3.1 Meaning and concept of Financial Development

3.3.2 Meaning and concept of Economic Development

3.3.3 Relationship between Financial and Economic Development

3.4 Flow of funds accounts

3.4.1 Principle of flow of funds

3.4.2 Importance of flow of funds accounts

3.5 Flow of Funds based Indicators of financial development

3.6 Summing Up

3.7 Model Questions

3.8 Bibliography/Suggested Readings

3.1 Introduction

A well-developed financial system contributes significantly towards the growth and development of an economy. The components of the financial system have a bearing on the economic prosperity of nations and their long-term development. Over the years, financial system has evolved in various dimensions such as modes of investment, types of securities offered for investment, and importantly, the increasing participation of people in the financial system across the globe. The government too has been playing an active role in promoting financial literacy amongst its citizens. In India, for example, the government has been actively involved in promoting financial inclusion by promoting zero-balance accounts under the 'Pradhan Mantri Jan Dhan Yojana scheme and brought a large stratum of the populace into the financial umbrella. Such initiatives throw light on the increasing importance of financial know-how and growth as a tool for achieving overall economic growth and development. We shall now try to explore some key aspects of

the above-mentioned areas and their inter-dependency which forms the basic foundation of this unit.

3.2 Objectives

After going through this unit, you will be able to–

- understand the inter-dependency between financial development and economic development,
- discuss the Flow of Funds Accounts framework and its significance in economic development,
- analyse various indicators that are considered important for financial development.

3.3 Financial and Economic Development

The question as to whether a well-developed financial system aids in economic development has been a topic of debate for policymakers as well as academia for many years now. However, many studies across the globe have highlighted the positive impact that a sound financial system has on the economic growth of a region. At this point, it becomes essential to explore the various components of a well-developed financial system and how it drives economic development.

3.3.1 Financial Development – Meaning and Concept

Financial development refers to the process of improving and strengthening the financial system within an economy. It involves the growth, efficiency, and effectiveness of financial institutions, markets, and related services. Financial development plays a crucial role in facilitating economic growth, reducing poverty, and promoting overall prosperity. This concept encompasses various factors, including the establishment of stable and trustworthy financial institutions, the development of diverse financial markets, the implementation of effective regulatory frameworks, and the promotion of financial inclusion to ensure broader access to financial services for individuals and businesses. Ultimately, the aim of financial development is to create a robust and well-functioning financial environment that contributes to the economic well-being and stability of a nation.

A well developed financial sector facilitates the efficient allocation of resources, mobilizes savings, and catalyzes investment, thereby contributing to sustained economic development. Let us now discuss the various components of financial development in detail:-

Components of Financial Sector Development:

1. **Financial Institutions:**

Financial institutions are organizations that provide a wide range of financial services to their customers and facilitate the management and flow of money in the economy. These institutions play a crucial role in the functioning of modern economies by offering services such as savings and checking accounts, loans, investments, and insurance. Financial institutions, including banks, insurance companies, and non-banking financial institutions, constitute the backbone of a country's financial sector. Their stability, efficiency, and outreach are crucial indicators of financial sector development.

2. Financial Markets:

Financial markets are platforms or systems where individuals, institutions, and governments can buy and sell financial securities, commodities, and other fungible items at prices determined by supply and demand. These markets facilitate the efficient allocation of capital, enabling businesses and governments to raise funds and investors to earn returns on their investments. The depth and liquidity of these markets are indicative of the level of financial sector development, influencing the ease with which funds can be raised and invested. Stock market, money market, commodities market etc. are few examples of financial market.

3. Regulatory Framework:

A well-designed and effectively implemented regulatory framework is essential for financial sector development. Regulations ensure the stability of financial institutions, protect consumers, and create an environment conducive to fair competition. A robust regulatory framework is essential for financial development as it fosters stability, protects stakeholders, and promotes market integrity. Regulations aim to prevent systemic risks and financial crises by setting standards for capital adequacy, risk management, and liquidity. Additionally, they enhance market confidence by ensuring fairness, transparency, and integrity, thereby encouraging participation and investment. Regulations also play a crucial role in protecting investors and

consumers through measures such as disclosure requirements and consumer protection rules. RBI (Reserve Bank of India), SEBI (Securities and Exchange Board of India), IRDA (Insurance Regulatory and Development Authority of India), FMC (Forwards Market Commission) to name a few, are some prominent regulatory bodies functioning in the Indian financial market.

4. Financial Inclusion:

Financial sector development includes efforts to enhance financial inclusion, ensuring that a larger proportion of the population has access to formal financial services. This involves expanding banking services, promoting microfinance, and leveraging technology to reach underserved areas.

5. Technological Advancements:

The integration of technology, such as digital banking and fintech solutions, plays a pivotal role in financial sector development. These innovations enhance efficiency, reduce costs, and increase accessibility, fostering a more inclusive and dynamic financial landscape.

Check Your Progress

1. What is financial development? What are the major components of financial sector development?
2. Explain the role of a robust regulatory framework in promoting financial development.

3.3.2 Economic Development – Meaning and Concept

Economic development is a comprehensive and multidimensional concept that goes beyond mere economic growth. It encompasses a broader vision of improving the standard of living, reducing poverty, and enhancing the well-being of individuals within a society. While economic growth focuses on the quantitative expansion of an economy, economic development delves into qualitative improvements, seeking to create sustainable and inclusive progress.

Key Elements of Economic Development:

1. Growth in Real Incomes:

Real income refers to an individual's or a household's income after accounting for inflation. In other words, it is the income adjusted for changes in purchasing

power, enabling one to determine the actual increase or decrease in purchasing power over time. Economic development involves the continuous increase in real incomes and living standards for the population. This includes improvements in wages, access to education, healthcare, and a range of goods and services that contribute to a better quality of life.

2. Reduction of Poverty:

Reducing poverty is fundamental for robust economic growth. By ensuring access to education, healthcare, and employment, we empower individuals to contribute more effectively to the economy. When there's a more balanced distribution of resources and opportunities, society benefits from increased stability and cohesion. Moreover, investing in sectors like small businesses and infrastructure amplifies economic potential, creating a ripple effect of opportunities. Essentially, addressing poverty is a strategic step towards building a resilient and prosperous economy for all.

3. Enhanced Human Capital:

Enhanced human capital plays a crucial role in fostering economic growth by contributing to increased productivity, innovation, and overall competitiveness. Human capital encompasses the knowledge, skills, and expertise that individuals acquire through education, training, and experience. As individuals enhance their human capital, they become more adept at utilizing new technologies, adapting to changing economic landscapes, and driving innovation. This, in turn, boosts productivity at both the individual and collective levels, leading to increased efficiency in production processes. Moreover, a well-educated and skilled workforce attracts foreign investments, stimulates entrepreneurship, and facilitates the adoption of advanced technologies, all of which are key drivers of economic growth.

4. Infrastructure Development:

Infrastructure development is vital for economic growth as it facilitates efficient transportation, boosts productivity, and attracts investments. A well-developed infrastructure network reduces transaction costs, connects regions, and enables businesses to operate more competitively. Additionally, it creates employment opportunities and stimulates economic activity, making it an indispensable element for economic growth and prosperity.

5. Technological Advancements:

Embracing and investing in technological innovations is a key driver of economic development. Technological advancements improve productivity,

create new industries, and enhance the competitiveness of a nation in the global arena.

6. Social Inclusion and Equality:

Social inclusion and equality are essential catalysts for sustainable economic growth as they ensure that all individuals, irrespective of their background, have equal access to opportunities, resources, and services. By promoting social inclusion, societies can harness the full potential of their diverse populations, fostering innovation, entrepreneurship, and creativity. Furthermore, when disparities in income, education, and access to essential services are minimized, a more equitable distribution of wealth and resources can stimulate consumer demand, drive investment, and enhance overall economic productivity. In essence, social inclusion and equality not only foster a more cohesive and resilient society but also create an environment conducive to robust and inclusive economic growth.

Indicators of Economic Development:

1. Gross Domestic Product (GDP):

Gross Domestic Product (GDP) is a key indicator of the economic performance of a country. It represents the total value of all goods and services produced over a specific time period within the borders of a country. GDP is often used as a measure of a nation's economic health and is a critical metric for assessing and comparing the economic performance of different countries. While not the sole measure, GDP remains a crucial indicator of economic development. It reflects the total value of goods and services produced within a country, providing an overall picture of economic activity.

2. Human Development Index (HDI):

The Human Development Index (HDI) is a statistical tool created by the United Nations to evaluate and compare the overall well-being and development status of different countries.HDI combines indicators such as life expectancy, education, and per capita income to provide a more holistic measure of development that considers both economic and social dimensions.

3. Poverty and Inequality Metrics:

Poverty and inequality metrics serve as critical indicators of the inclusivity and sustainability of economic growth. While traditional economic indicators such as GDP growth rates provide a broad overview of economic

performance, they often overlook disparities in income distribution and access to essential services. High levels of poverty and widening inequality can be indicative of systemic flaws in the economic structure, as they reflect unequal opportunities and limited access to resources for a significant portion of the population. Moreover, persistent poverty and inequality can hinder social mobility, undermine social cohesion, and lead to socio-political instability, thereby posing long-term risks to economic development. As such, monitoring poverty and inequality metrics alongside conventional economic indicators offers a more comprehensive understanding of the quality and sustainability of economic growth, highlighting areas that require targeted interventions and policy reforms to foster a more equitable and inclusive society.

4. Infrastructure and Technological Indicators:

Infrastructure and technological indicators are like a report card for an economy's ability to grow and innovate. Infrastructure indicators, like roads and internet access, show how well-connected and ready an economy is for business. Think of it as the backbone that helps businesses operate smoothly and attract investments. Meanwhile, technological indicators, such as new inventions or digital adoption rates, tell us how innovative an economy is. Higher innovation often means more efficient businesses and new job opportunities. In essence, these indicators help us understand if an economy is well-prepared, connected, and ready to embrace new technologies, which are key ingredients for economic growth.

Check Your Progress

1. Write the meaning of economic development. Explain the key elements of economic development.
2. Explain the important indicators of economic development.
3. Highlight the role of technological advancement in promoting economic development.

3.3.3 Relationship Between Financial Development and Economic Development

Financial development and economic growth are closely intertwined. When a country's financial systems, like banks and stock markets, become stronger

and more advanced, it helps the overall economy to grow faster. This is because better financial systems make it easier for businesses to get money, manage risks, and expand. As the economy grows, it creates more jobs, encourages innovation, and generally improves the living standards of the people. So, a healthy financial system is the key to a country's progress and prosperity. The relationship between a healthy financial system and economic growth can be highlighted through the following points:-

1. Efficient Financial System and Economic Growth:

A good financial system helps our economy work better and grows faster. Financial markets can be thought of like bridges that connect people who save money with those who want to invest or start businesses. This connection means that money flows where it's needed most, helping businesses grow and giving people chances to make their money grow too. So, when our financial system works well, it helps everyone by making our economy stronger and more efficient.

2. Financial Structure as a Prerequisite for Growth:

A robust financial structure serves as a foundational pillar for economic advancement. When effectively established, this system ensures that savings are channeled into productive investments, bolstering growth and innovation across various sectors. By facilitating the efficient allocation of resources, it fosters a conducive environment for businesses to expand and for the economy to flourish. In essence, a well-functioning financial system plays a critical role in optimizing capital utilization and driving sustainable economic growth and development.

3. Mobilization of Savings:

By providing accessible and efficient channels for individuals and businesses to save and invest, the financial system not only encourages a higher volume of savings but also stimulates the rate at which savings contribute to overall economic development. In essence, a well-developed financial system acts as a catalyst, ensuring that savings are effectively harnessed and redirected towards productive investments, thereby fueling economic growth and development.

4. Competition and Lower Intermediation Costs:

Enhanced competition within the financial system plays a pivotal role in reducing intermediation costs. As costs decrease, financial services become more accessible and affordable to a broader segment of the population.

This accessibility not only encourages greater investment activity but also facilitates the efficient allocation of resources. By lowering barriers to entry and enhancing service affordability, increased competition within the financial sector fosters a more inclusive and dynamic environment. Ultimately, this leads to accelerated economic growth, as more individuals and businesses can effectively access and utilize essential financial services to support their growth and development initiatives.

5. Corporate Sector Management and Governance:

The financial system helps manage and guide businesses. It encourages companies to follow good rules and practices, making sure they operate in a stable and accountable way. By promoting these good practices, the financial system builds trust among everyone involved and helps businesses make better decisions. In simple terms, a strong financial system ensures that businesses act responsibly, which is important for keeping our economy steady and growing.

6. International Linkages and Capital Flow:

Integration with the international financial system facilitates increased capital flow within financial markets. This interconnectedness not only draws foreign investments but also catalyzes economic growth. Furthermore, it opens doors for domestic businesses to tap into global market opportunities, fostering expansion and diversification on a global scale.

7. Role of Financial Markets in Capital Allocation:

Financial markets, such as stock exchanges and bond markets, play a central role in allocating capital to businesses which in turn boosts economic growth.

Stop to Consider

Do you think that a well developed financial system aids in economic development. Make an analysis of the financial system and economic development of U.S.A, India and Bangladesh.

3.4 Flow of Funds Accounts

Flow of funds refers to financial reports or accounts that illustrate the inflow and outflow of funds to and from various sectors in an economy. The FOF accounts examine the flow of fund in an economy across six sectors, viz.

households, government, private corporations, banks, other financial institutions (OFI's) and rest of the world. The flow of funds accounts are compiled and published by the respective central banks of different countries on a periodical basis. The Reserve Bank of India has been publishing the flow of funds accounts for the Indian economy since 1964. In fact, India has been one of the early adopters of a domestic Flow of funds framework. The flow of accounts system was suggested as an alternative to the erstwhile national accounts system in 1947 by Morris Copeland. The flow of funds accounts is an approach whereby the flow of funds to and from different sectors (as mentioned above) is analyzed in order to assess the depth and maturity of a financial market in an economy. Let us now explore the fundamentals of the flow of funds framework and its significance:

3.4.1 Principle of Flow of Funds

In simple words, the flow of funds reflects the transactions that include buying and selling of goods and services along with the transfer of assets (uses of fund) and liabilities (sources of fund) between different sectors at a particular point in time. It includes crucial information on various sectors of the economy and aids policymakers in decision-making. By showing the sectoral presentation of the flow of funds and their usage, this accounting framework addresses a major problem that was encountered in the national income accounting system that was in use previously. The flow of funds accounts captures the timing, pattern, and duration of money flows within an economy thereby providing an effective measure of the nature of financial claims in an economy.

The flow of funds framework uses the double-entry accounting system in order to assess the flow of funds or to track the changes in assets and liabilities across various sectors of the economy viz. households, government, private corporations, banks, other financial institutions (OFI's) and rest of the world. The flow of funds matrix will reveal the sources and uses of funds for each of the above -mentioned sectors at different point in time. The changes in assets are recorded as the use of funds and changes in liabilities as the source of funds. In the case of uses of funds, a positive figure denotes an increase in the asset while a negative figure will denote a decrease in the value of asset. On the other hand, in sources of funds, a positive figure denotes an increase in liability or savings while a negative figure will denote repayment of a debt or dissavings. It is worth noting that

in the case of a single sector, the value of its liability may not tally with the value of its total financial assets. In other words we can say that there can be imbalances in assets and liabilities on an individual sectoral basis, but when it comes to the entire economy, the total liabilities must be equal to the total assets.

Financial claims are divided into two categories – (i) Primary issues or securities signifying all forms of debt, marketable or otherwise issued by the ultimate borrowers and (ii) Secondary issues or indirect securities reflecting debt and claims issued by financial intermediaries in order to acquire and hold primary securities. The total flow of finance in the economy is represented by the total financial issues, which is the aggregation of funds raised through primary and secondary issues. Also known as financial stocks and flows, they are compiled and presented in a tabular form often referred to as a matrix in order to efficiently depict the sources and uses of funds across various sectors of the economy. The basis of presenting the sectoral flow of funds on a tabular basis is also referred to as 'FWTW' (From whom to whom) basis.

Check Your Progress

1. What is the significance of double -entry system of bookkeeping in the preparation of flow of funds accounts?
2. Is the flow of funds framework representative of the informal sector also? Name the nodal agency which is responsible for compiling and presenting data related to the informal sector of our country.

3.4.2 Importance of Flow of Funds Accounts

The significance of flow of funds accounts can be analyzed from the following points:-

(1) By presenting the flow of funds across various sectors, it helps in highlighting the role played by the financial sector towards the development of a nation;

(2) They facilitate a thorough analysis of the economic data pertaining to borrowings, savings and lending across vital sectors of the economy;

(3) Serves as an information tool for the central banking authority and aids in formulation of fiscal and monetary policy;

(4) They help in assessing the behavior of individual financial institutions operating in the economy;

(5) They provide useful insights as to how the government finances its surplus and deficit budget;

(6) They help in measuring the economic activities which in turn aids in predicting changes in GDP (Gross Domestic Product).

Despite advantages linked to the flow of funds accounts framework one has to as well take into consideration the limitation associated with this framework. A major drawback of the flow of fund accounts framework is that it does not provide a complete representation of the transactions that occur in the informal/unorganized sector. One has to acknowledge the contribution made by the informal sector towards economic growth of a nation but owing to certain technical issues, the financial transactions occurring in the informal sector are not adequately represented in the flow of funds accounting framework. Some of the difficulties associated with the measurement of the informal/unorganized sector have been listed below:-

(a) The data of actual workforce engaged in this sector is not conclusive which is why any efforts on the part of authorities concerned to extract information in this regard shall not be entirely representative;

(b) Majority of the transactions that occur within the informal sector are primarily settled on cash basis and hence unaccounted for. Simply stated, the extent of expenditure incurred in the informal sector can be assessed but, the amount of income generated through such transactions remain unaccounted as they are not settled through a formal institution such as a bank but in cash;

(c) The enterprises engaged in this sector comprise of enterprises owned by individuals or households that do not have a separate existence from their owners. As such, there is no separation of financial activities of the owner and the enterprise which is why it is difficult to derive a complete set of financial information from the firms engaged in the informal sector.

3.5 Flow of Funds Based Indicators of Financial Development

The flow of funds accounts serve as a critical indicator of financial development due to their ability to capture the intricate dynamics of capital movement within an economy. These accounts offer insights into the depth,

breadth, and efficiency of financial markets by revealing the allocation of funds across various sectors and instruments. A developed financial system is typically characterized by efficient intermediation, where funds are effectively channeled from savers to productive investments, and by diverse markets that facilitate risk diversification and liquidity provision. Flow of funds data can highlight the extent of capital allocation efficiency, the inclusiveness of financial access, and the resilience of the financial system to shocks. Furthermore, by analyzing the interconnectedness among institutions and markets, flow of funds accounts can provide valuable information on systemic risks and potential contagion effects. Thus, flow of funds accounts not only offer a comprehensive view of the financial landscape but also inform policymakers and stakeholders about the strengths, weaknesses, and areas for improvement in a country's financial system, guiding efforts towards sustainable and inclusive financial development. Let us now consider the flow of fund based indicators of financial development:-

***1. Finance Ratio (FR)* –** Finance Ratio depicts the rate of financial development in relation to economic growth. It expresses the relationship between the total issues (consisting of primary and secondary claims) and national income in an economy. It can be calculated as follows:-

FR = Total financial claims/Net income = Total issues/Net national product at factor cost.

***2. Financial Inter-relation Ratio (FIR)* –** This ratio reflects the proportion of financial issues with respect to net capital formation in an economy. It reflects the relationship between the financial structure and capital formation in the economy. It is calculated as follows:-

FIR = Financial assets/Physical assets = Total issues/Net domestic capital formation.

***3. New Issue Ratio (NIR)* –** It Is the ratio of primary issues to net domestic capital formation. It measures the proportion of primary claims issued by non-financial institutions to net capital formation. It can be calculated as follows:-

NIR = Primary issues/Net physical investments = Primary issues/ Net domestic capital formation.

***4. Intermediation Ratio (IR)* –** It is the ratio of secondary issues to primary issues and indicates the importance of financial intermediaries in channelizing financial resources. It is calculated as follows:-

IR = Total secondary issues/Total primary issues.

Check Your Progress

1. State the meaning of flow of funds accounts? Who is responsible for compiling and presenting the data related to flow of funds accounts in an economy?
2. What are the various sectors on which the flow of funds accounts is based?
3. Explain the various flow of funds based indicators of financial development.

3.6 Summing Up

After considering different aspects of the financial system, we can say that there is a direct relationship between financial development and economic development. Factors such as improvement in financial infrastructure and increased technical knowhow have a direct bearing on the state of economic affairs of a country. However, it is also important to note the differences between economic growth and development. Economic growth is a short-term aspect and economic development on the other hand, is a result of sustained economic growth over a certain period of time. Economic growth may be defined as the positive change in the real output of the country over a particular span of time reflected through measures such as GDP (Gross Domestic Product) and GNP (Gross National Product). It refers to the rate of growth in real output over population growth for a particular span of time. Economic Development is on the other hand, a manifestation of the welfare of the residents in a country driven by increase in economic wealth of the country. This ultimately leads us to believe that economic growth is an important but not the only attribute for attainment of Economic Development. Efficient functioning of the financial system aids in economic growth which in turn results in economic development. While economic growth is characterized by improvement in factors such as human and natural resources, capital formation and technological development etc. economic development on the other hand is characterized by improvement in factors such as Life expectancy rate, Maternal mortality rate, Rate of employment etc.

The Flow of funds accounts framework and its significance in the economy as a tool for promoting growth can hardly be overlooked. It refers to compiling and presenting data from six vital sectors of the economy in order

to assess the depth and maturity of the financial system of an economy. The central banking authority is responsible for publishing data related to flow of fund accounts on periodic intervals. It also assists the central bank in policy formulation and proper planning as per the needs of the economy. A set of ratios known as flow of funds based indicators helps in examining the changes in flow of funds and drawing inferences regarding financial development in the economy.

As discussed above, economic development is a result of sustained efforts towards economic growth for a longer period of time. While there are a different set of parameters that define them, both economic growth and development are crucial for the healthy growth of the economy. The financial system represents the deep end of the financial system. A stable and resilient financial system stimulates capital flow and accelerates economic growth. A sound financial system is vital for economic transformation as achievement of broader national objectives is also dependent on the efficiency of the financial system.

3.7 Model Questions

1. Explain with examples the importance of financial innovation in promoting an efficient financial system.
2. What do you mean by Financial Net worth? How is it calculated?
3. How is the flow of funds data derived for the household sector within the flow of funds framework?
4. What do you understand by financial development? Explain the indicators that are considered vital for financial development.
5. How does an efficient financial system promote capital formation in an economy? Explain with suitable examples.
6. Highlight the differences between economic growth and economic development?

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Unit-4
Reforms in The Indian Financial System

Unit Structure:

4.1 Introduction
4.2 Objectives
4.3 Meaning of financial sector reforms
4.4 Objectives of Financial Sector Reforms
4.5 Reforms in the Indian Financial System
  4.5.1 The period from 1947 to 1960
  4.5.2 The period from 1960 to 1980
  4.5.3 The period from 1980 to 1990
  4.5.4 The Period from 1990 to 2000
  4.5.5 The period from 2000 to the present
4.6 Summing Up
4.7 Model Questions
4.8 References and Suggested Readings

4.1 Introduction

Financial sector reforms are policy measures designed to deregulate the financial system and transform its structure with the view to achieve a liberalized market-oriented system within an appropriate regulatory framework. Financial system in any country is a changing phenomenon. Generally, due to the changing of trade, business, industry along with their market position, the change in financial system is inevitable. The financial system should be reformed from time to time so that it can adapt to the changing economic and financial environment and can provide sufficient support for growth of financial and economic activities. Since the last few decades, it has been observed that significant changes have taken place and subsequently various reforms have been made in the Indian financial system. The main purpose of this unit is to discuss various aspects of financial reforms in Indian financial system.

4.2 Objectives

After going through this unit, you will be able to–

- *understand* financial reforms,
- *explain* the objectives of financial sector reforms,
- *discuss* reforms in the Indian financial system.

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4.3 Meaning of Financial Sector Reforms

Financial sector reforms means to improve the allocative efficiency of resources and ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. The main purpose of financial sector reform is to increase the return on investment and accelerate economic growth through efficient allocation of resources. *In other words, financial sector reforms are policy measures designed to deregulate the financial system and transform its structure with the view to achieving a liberalized market-oriented system within an appropriate regulatory framework.* At global level, financial sector reforms have been driven by two apparently contrary forces. The first is a thrust towards liberalization, which seeks to decrease, if not eliminate a number of direct controls over banks and other financial market participants. The second is a thrust in favour of strict regulation of the financial sector. This dual approach is also apparent in the reforms in India.

4.4 Objectives of Financial Sector Reforms

Financial sector reforms generally aim to achieve several objectives, including:

a) Enhancing Stability: The prime objective of financial sector reform is to enhance the overall stability of the financial system to prevent systemic risk and crisis.

b) Improving Efficiency: Reforms are undertaken to improve the efficiency of financial intermediation, ensuring that capital is allocated more efficiently.

c) Increasing Transparency: Reforms aims at increasing transparency and disclosure. This will increase the confidence of the stakeholders and investors.

d) Promoting Inclusion: Promoting financial inclusion and making financial service accessible to the wider section of the population is one of the main aim of financial sector reforms.

e) Encouraging Competition: Financial sector reforms encourage healthy competition within the financial sector to drive innovation and improve financial services.

f) Strengthening Regulatory framework: Financial sector reforms aims at strengthening and modernizing regulatory framework to ensure that they are responsive to new market dynamics.

g) Enhancing Risk management: Financial sector reforms aim at enhancing risk management practices to mitigate potential threats to the financial system.

h) Investor Protection: Financial sector reforms aim at increasing the measures to protect the interest of investors and consumers within the financial market.

i) Global Integration: Aligning the financial system with global standards to facilitate international transactions and collaborations is one of the important objectives of the financial sector reforms.

4.5 Reforms in the Indian Financial System

India's financial sector is dynamic, diversified and expanding rapidly. It comprises of financial markets, institutions or intermediaries, financial instruments and financial service. Financial intermediaries are a dominant part of the financial sectors followed by the insurance companies. Various reforms in the financial system of India are discussed under the following points.

4.5.1 The Period from 1947 to 1960

The period from 1947 to 1960 in India was marked by significant reforms in the financial system, as the newly independent nation sought to build a stable and resilient economic framework. These reforms collectively *aimed at creating a robust financial system that could support the planned economic development of India in the post-independence period*. The period laid the groundwork for subsequent economic policies and reforms that shaped the trajectory of India's economy in the following decades. The following are some of the reforms during this period:

- **Nationalisation of Reserve Bank of India:** The RBI, India's central banking institution, was established in 1935 under the RBI Act and was nationalized on 1st January,1949 under the Reserve Bank of India (Transfer to Public Ownership) Act, 1948. This move aimed to centralize the control of currency and credit, providing a unified regulatory authority for the country's financial system.
- **Banking Regulation Act, 1949:** Banking Regulation Act 1949 was enacted with the objective of providing specialized legislation with comprehensive regulations, especially for banking market in India, to prevent bank collapse and to ensure healthy expansion of banks.
- **Nationalization of Imperial Bank of India (1955):** The Imperial Bank of India, a private bank, was nationalized and restructured into the State Bank of India (SBI). This step was taken to promote the development of banking services across the country and ensure government control over a major financial institution.
- **Formation of Industrial Finance Corporation of India (IFCI) in 1948:** IFCI was established to provide long-term finance to industrial projects, promoting industrialization and economic development in the country.
- **Nationalization of Life Insurance (1956):** The Life Insurance Corporation of India (LIC) was created by nationalizing existing private life insurance companies. This move aimed to bring life insurance services under government control and extend insurance coverage to a larger population.
- **Monetary Policy and Planning:** The government adopted a planned approach to economic development, and the RBI played a crucial role in formulating and implementing monetary policies to support planned economic growth.
- **Introduction of the First Five-Year Plan (1951-1956):** The First Five-Year Plan laid the foundation for economic development, emphasizing key sectors like agriculture, industry, and infrastructure. Financial institutions played a vital role in funding and supporting the planned development projects.
- **Formation of Development Financial Institutions (DFIs):** The government established DFIs such as the Industrial Credit and

Investment Corporation of India (ICICI) in 1955 to provide long-term financial assistance for industrial projects.

- **Reorganization of State Finances:** Efforts were made to reorganize state finances to ensure fiscal discipline and proper management of resources. This included the implementation of the recommendations of the Finance Commission.
- **Currency Reforms:** There were currency reforms aimed at stabilizing and modernizing the monetary system. This included the demonetization of high-value currency notes in 1946 and the issuance of new currency notes.

4.5.2 The Period from 1960 to 1980

The period from 1960 to 1980 in India witnessed significant reforms in the financial system, *aimed at promoting economic development, enhancing financial inclusion, and ensuring stability*. These reforms played a pivotal role in shaping the Indian financial system, making it more inclusive, competitive, and responsive to the diverse needs of the economy. The following are some reforms during this period:

- **The Industrial Development Bank of India (IDBI)** was established in 1964 to provide long-term financial assistance for industrial projects.
- **Nationalization of Banks (1969):** In 1969, major banks in India were nationalized with the objective of spreading the banking network to rural and semi-urban areas. The move was aimed at directing credit towards priority sectors such as agriculture, small-scale industries, and exports.
- **Creation of Regional Rural Banks (RRBs):** The government established RRBs in 1975 to cater specifically to the banking needs of rural areas. RRBs were created to bridge the gap between formal banking institutions and the rural population, promoting agricultural and rural development.
- **Lead Bank Scheme (1969):** The Lead Bank Scheme was introduced to assign lead roles to individual banks in each district to coordinate and promote banking activities. The lead bank was responsible for ensuring credit flow to all sectors in the district and coordinating the efforts of all banks operating in the area.

- **Introduction of Money Market Instruments:** During this period, various money market instruments were introduced to enhance the efficiency of the financial system. Treasury bills, commercial paper, and certificate of deposits gained prominence, providing short-term liquidity to financial institutions.
- **Establishment of National Housing Bank (1988):** The National Housing Bank (NHB) was set up in 1988 to promote housing finance institutions and provide a regulatory framework for housing finance activities. NHB aimed at channelizing resources into the housing sector, fostering home ownership and urban development.
- **Creation of Securities and Exchange Board of India (SEBI) (1988):** SEBI was established to regulate and develop the securities market in India. It aimed to protect the interests of investors, promote fair and transparent dealings in the securities market, and ensure the development of a vibrant capital market.
- **Liberalization of Interest Rates:** The 1970s and 1980s saw a gradual move towards the liberalization of interest rates, allowing banks to determine their lending and deposit rates based on market forces. This move aimed at promoting efficiency in the financial system and enhancing competition among financial institutions.
- **Development of Non-Banking Financial Companies (NBFCs):** The period witnessed the growth of NBFCs, contributing to the diversification of the financial system. NBFCs played a crucial role in providing credit to sectors not adequately served by traditional banks.

4.5.3 The Period from 1980 to 1990

The period from 1980 to 1990 witnessed significant reforms in the financial system of India, *aimed at liberalizing and modernizing the economy*. These reforms were part of the broader economic liberalization and structural adjustment policies initiated to address the challenges faced by the Indian economy. These reforms laid the foundation for the transformation of India's financial sector, setting the stage for further liberalization in the following decades. The 1990s marked a turning point in India's economic policies, leading to increased integration with the global economy and a shift towards a more market-oriented approach. The following are some reforms in the Banking sector during this period:

I) **Banking Sector Reforms:**

a. **Nationalization of Banks (1969 and 1980):** The process of nationalization of banks, which began in 1969, continued in the 1980s. In 1980, six more banks were nationalized, bringing the total number of nationalized banks to 20. This move was aimed at ensuring greater control over the banking sector and directing credit towards priority sectors.

b. **Lead Bank Scheme (1982):** The Lead Bank Scheme was introduced to improve the coordination between commercial banks and other financial institutions to enhance the efficiency of credit delivery in rural areas.

c. **Prudential Norms (1985):** The Reserve Bank of India (RBI) introduced prudential norms to strengthen the financial health of banks. This included guidelines on income recognition, asset classification, and provisioning for non-performing assets.

4.5.4 The Period from 1990 to 2000

From 1990 to 2000, India underwent significant reforms in its financial system during the post-independence period, with a particularly noteworthy phase. These reforms were *aimed at liberalizing and modernizing the financial sector to foster economic growth and development.* The financial reforms during the post-independence period from 1990 to 2000 played a crucial role in transforming India's financial landscape, making it more competitive, resilient, and aligned with global standards. The following are some of the financial reforms during this period:

I) **Liberalization of the Economy (1991):**

a. In 1991, India faced a severe economic crisis, prompting the government to initiate a series of economic reforms under the leadership of then-Finance Minister Dr. Manmohan Singh.

b. The reforms included dismantling the License Raj, reducing trade barriers, and encouraging foreign direct investment (FDI).

II) Financial Sector Reforms:

a. **Banking Sector Reforms:**

- The Narasimham Committee (1991) and Narasimham Committee II (1998) recommendations were implemented to strengthen the banking sector.
- Emphasis on prudential norms, asset classification, and income recognition (NPA classification).
- Encouraged the establishment of private sector banks.

b. **Liberalization of Interest Rates (1991):** The government began the process of interest rate liberalization to allow banks to set their own interest rates based on market conditions. This move aimed at making the financial sector more competitive and efficient.

c. **Entry of Private Sector Banks (1993):** The government allowed the entry of private sector banks, breaking the monopoly of public sector banks. This led to increased competition and efficiency in the banking sector.

d. **Capital Market Reforms:**

- **Establishment of NSE (National Stock Exchange) in 1992:** The National Stock Exchange was set up to modernize and streamline the stock trading process. It introduced electronic trading systems, dematerialization of shares, and screen-based trading, bringing greater transparency and efficiency to the capital market.
- **SEBI Act (1992):** The Securities and Exchange Board of India (SEBI) was established in 1988, and the SEBI Act was enacted in 1992 to provide statutory powers to SEBI. SEBI was tasked with regulating the securities market and protecting the interests of investors.

III) Foreign Exchange Reforms:

a. **Creation of NRI Investment Window (1991):** The Non-Resident Indian (NRI) Investment Window was created to attract foreign exchange from NRIs and promote foreign direct investment.

b. **Liberalization of Foreign Exchange (1999):** The government undertook major reforms in the foreign exchange market, liberalizing

trade and current account transactions. The dual exchange rate system was abolished, and the rupee was made partially convertible.

IV) Introduction of New Financial Instruments:

a. Derivatives trading was introduced in 2000 to manage risk in the financial markets.

b. Securities lending and borrowing were permitted to enhance market liquidity.

V) Technology Integration:

a. The adoption of technology in the financial sector increased, with the introduction of electronic banking and online trading platforms.

b. The use of Information Technology was encouraged to improve efficiency and reduce costs.

VI) Insurance Sector Reforms:

a. The insurance sector was opened up to private players in 2000, breaking the monopoly of state-owned companies.

b. The Insurance Regulatory and Development Authority (IRDA) was established to regulate the insurance industry.

VII) Pension Reforms:

a. The New Pension System (NPS) was introduced in 2004, allowing individuals to contribute to a pension fund for their retirement.

VIII) Microfinance and Financial Inclusion:

a. Efforts were made to promote microfinance institutions to address the financial needs of the rural and underserved population.

b. Focus on financial inclusion through initiatives like the Pradhan Mantri Jan Dhan Yojana.

4.5.5 The Period from 2000 to the Present

India has undergone significant reforms in its financial system since gaining independence in 1947. In the period from 2000 to the present, several reforms have been implemented *to enhance the efficiency, stability, and inclusiveness of the financial system.* These reforms collectively reflect India's commitment to creating a more dynamic, inclusive, and resilient financial system in the post-independence period up to the present day. Some important reforms are:

- **Liberalization and Deregulation (1990s-2000s):** The most significant financial reforms in India began in the 1990s with the liberalization and deregulation of the economy. The government initiated a series of measures to open up the financial sector, including the entry of private and foreign banks, liberalized foreign direct investment (FDI) policies, and the establishment of the Securities and Exchange Board of India (SEBI) to regulate securities markets.
- **Banking Sector Reforms (2000s):** The Reserve Bank of India (RBI) introduced reforms to strengthen the banking sector. The National Electronic Funds Transfer (NEFT) system was introduced in 2005 to facilitate electronic funds transfer between banks. The adoption of Basel II norms for risk management and capital adequacy further improved the resilience of Indian banks.
- **Financial Inclusion Initiatives (2005 Onwards):** The Indian government launched various initiatives to promote financial inclusion, ensuring that a larger portion of the population has access to banking and financial services. The Pradhan Mantri Jan Dhan Yojana (PMJDY), launched in 2014, aimed to provide financial services to the unbanked population, including no-frills bank accounts, insurance, and pension schemes.
- **Insolvency and Bankruptcy Code (IBC) (2016):** The Insolvency and Bankruptcy Code was introduced to expedite the resolution of insolvency cases and improve the ease of doing business. It provided a comprehensive framework for the insolvency and liquidation of companies, promoting a more efficient and transparent resolution process.
- **Demonetization (2016):** While controversial, demonetization aimed to curb black money, corruption, and counterfeit currency. The sudden withdrawal of high-denomination currency notes led to increased digital transactions and a push towards a more cashless economy.
- **Digital India and Fintech:** The government has been actively promoting the Digital India campaign, encouraging the use of technology in financial services. Fintech companies have played a crucial role in this transformation, offering innovative solutions such as digital payments, peer-to-peer lending, and robo-advisors.

- **Asset Quality Review (2015-2016):** The RBI conducted Asset Quality Reviews to assess the true health of banks and identify non-performing assets (NPAs). This exercise aimed to enhance transparency and accountability in the banking sector.
- **Goods and Services Tax (GST) (2017):** Although not directly a financial sector reform, the implementation of the Goods and Services Tax (GST) in 2017 significantly impacted the financial landscape. It replaced a complex system of indirect taxes with a unified tax structure, streamlining taxation and promoting ease of doing business.

Stop to Consider

Block chain technology is fast becoming one of the most rewarding trends in financial services due to its various tools and techniques that make business transactions occur efficiently and effectively.

Check Your Progress

1. In which year SEBI was established?
2. Define NBFCs.
3. What does the reforms from the period 1945 to 1960 aim at?
4. When and why were the RRBs established?
5. Why and when was the Insolvency and Bankruptcy Code Introduced?

4.6 Summing Up

During the last many years, there have been major improvements in the functioning of various financial market contributors. The government and the regulatory authorities have been adopting a step-by-step approach. The entry of multinational companies has forced to adopt international practices and systems. Technology developments have enhanced customer service. In spite of all these, few gaps are still remaining such as lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market. Since 1991, the cumulative effect of the developments has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.

The financial sector is the principal element of the Indian economic system. It is suggested by many financial experts that there is a need for effective reforms for the purpose of ensuring that this remains competitive and attractive for investors throughout the world. The economic reforms have preferred the need for changing the policy objective to promote industries and develop more integrated infrastructural facilities. Financial sector reforms are centre point of the economic liberalization that was introduced in India in mid-1991. Financial Liberalization in India has brought about the deregulation of interest rates, dismantling of directed credit, improving the banking system, enhancing the functioning of the capital market that include the government securities market. In order to improve economic conditions of India, more emphasis was given by regulators and economic experts on banking reforms. Basic purpose of financial sector reforms in the 1990s was to create a competitive environment that can lead to a steady growth and progression. Financial sector reforms means to improve the allocative efficiency of resources and ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency.

4.7 Model Questions

1. What is Financial System?
2. What do you mean by Financial Sector Reforms?
3. Discuss the various aims and objectives of financial sector reforms.
4. Discuss the major financial sector reforms from the period of 1945 to 1960.
5. Discuss the major financial sector reforms from the period of 1960 to 1980.
6. Discuss the major financial sector reforms from the period of 1980 to 1990.
7. Discuss the major financial sector reforms from the period of 1990 to 2000.
8. Discuss the latest financial sector reforms undertaken in India.

4.8 References and Suggested Readings

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