

Paper
Financial Institutions and Markets
M.A. 3rd semester

INTRODUCTION TO FINANCIAL SYSTEM
(Part I)

Financial system prevailing in any country plays an important role in rapid economic development of a country. The economic history of all developed countries of the world accepts the fact that their journey from underdeveloped Countries to a developing country and from a developing country to a developed country, it was possible only due to strong financial system. In a financial system of any developed country, which includes its banks, stocks markets, insurance sectors, pension funds, and a government-run central bank with authority. These sectors influence a nation's currency and interest rates. In developed countries, they work together to promote growth and avoid runaway price inflation. When a country is still in a developing stage, the lack of a strong sound financial system generally works against the national economy.

The development of any country depends on the economic growth that the country achieves over a period of time. Economic growth deals about investment and production and also the extent of Gross Domestic Product in a country. Only when this grows, the people will experience growth in the form of improved standard of living, namely economic development. Economic development includes the development of agriculture, industry, trade, transport, means of irrigation and power resources. It also refers to that process by which per capita income and economic welfare increase over a time.

Thus, the financial system of a country is an important tool for economic development of the country, it helps in creation of wealth by linking the savings with investments. It also facilitates the flow of funds from the households, to aid in wealth creation and development of both. Not only that, the financial system of a country is concerned with the allocation of savings, provisions of funds, facilitating the financial transactions, developing the financial market, provision of legal institutions, financial services, financial markets and financial instruments.

Meaning

The financial system refers to set of complex and inter connected components consisting specialized and non-specialized financial institutions, organized and unorganized financial markets, financial instruments and financial services. The aim of the financial system is to facilitate the circulation of funds in an economy. It is concerned about money, credit, and finance. Money refers to the medium of exchange or mode of payment. Credit refers to the amount of debt which is returned along with the interest. And the finance refers to the monetary resources comprising the own funds and debts of the state, company or a person.

The efficient financial system and sustainable economic growth are corollaries. The financial system mobilizes the savings and channelizes them into productive activity and thus

influences the pace of economic development. Economic growth is hampered for want of an effective financial system. Broadly speaking, financial system deals with three inter-related and interdependent variables, i.e., **money, credit, and finance**.

In other way, Finance means funds of monetary resources required by individuals, business-houses and the government for their varied needs. The financial system refers to the system of borrowing and lending of funds to all individuals, institutions, companies and all of governments.

Financial system is a set of institutions, such as banks, insurance companies, and Stock Exchange, that permit the exchange of funds.... borrowers, lenders, and investors exchange current funds of finance projects, either for consumption or productive investments, and to pursue a return on their financial assets.

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

In other words or in a simple way, we can describe that of a financial system is a set of institutions, such as banks, insurance companies , and Stock Exchange that permit the exchange of funds. . Financial systems exist on firms, regional and global level. Borrower, lenders and investors exchange current funds to finance projects either for consumption or protective investments and to pursue a return on their financial assets. The financial system also includes set of rules and practices that borrower and lender use to decide which project get financed ,who finances projects, and terms of financial deals.

Financial system provides a mechanism by which savings are transformed into investments, it plays a significant role in economic growth of the country by mobilizing surplus funds and utilizing them effectively for productive purpose.

The term **Financial System** is a set of inter related activities or services working together to achieve some pre determine purpose or goal. It includes different markets, the institutions, instruments, services, investments, and capital formation. The Indian financial system has established a strong link between both savings and investments by creating a unique mechanism through which varied economic activities are created, sustained and development.

Financial system includes many institutions and the mechanism which affects the generation of savings, mobilization of savings and effective distribution of savings. Thus Indian financial system performs a crucial role known as **capital formation**. It is for this reason that the financial system in sometimes called the **Financial Market** .The purpose of financial market is to mobilise savings effectively and allocate the same efficiently among the investors.

Definitions

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

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

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

“The purpose of financial markets is to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption.”- VAN HORNE

From the above definitions it can be concluded that the primary function of the financial system is the mobilisation of savings, their distribution for Industrial investment and simulating capital formation to accelerate the process of Economic Growth.

The process of savings, finance and investment involves financial institutions, markets, instruments and services. Above all supervision control and regulation are equally significant. The financial management is an integral part of the financial system.

A Financial system provides services that are essential in a modern economy. The use of a stable,, widely accepted medium of exchange which reduces the costs of transactions. The financial system has been identified as the most catalysing agent for growth of the economy for making it one of the key inputs of development.

According to **Amit Chaudhary**,

“Financial system is the integrated form of financial institutions, financial markets, financial securities, and financial services which aim is to circulate the funds in an economy for economic growth.”

According to **Dhanilal**,

“Financial system is the set of interrelated and interconnected components consisting of financial institutions, markets, and securities.”

Features of Financial system

The features of the financial system are as follows ---

1. Financial system provides an ideal linkage between depositors and investors, thus encouraging both savings and investments.
2. Financial system facilitates expansion of financial markets over space and time.

3. Financial system promotes efficient allocation of financial resources for socially desirable and economically productive purpose.
4. Financial system influences both the quality and the pace of economic development.

Some other features of financial system are as follows:

- a) Financial institutions: under financial system there are numerous institution and these institution collect the public savings with themselves and encourage the public for saving and also provide credit to the needy persons.
- b) Financial process: under financial system, capital is formed by the process of finance. This process can be explained this way.

Income → Saving → Investment → Capital formation

- c) Parts of financial system: Banks, insurance companies, unit trust of India, and other such financial institutions are a part of financial system. Through these institutions using various plans and medium, interest are created among the people. Financial system renders its services to both lender and borrower.
- d) Stability in money market: just like commodity, fluctuation also takes place in the value of money. Due to maximum fluctuation the prosperity of the country can be damaged. Thus, strong financial system brings stability in money market.
- e) Liquidity: through financial system wealth is converted into liquid money and is used in those areas where maximum profit can be extracted.

❖ *Chapter continued in Part II*

REFERENCES

1. Bhole L M, “Financial Institutions and markets”, Tata McGraw-Hall, New Delhi, 1999.
2. 1999.
3. Khan M Y, “Indian Financial System, Tata Mc Graw-Hill, New Delhi, 2001.
4. Pandey I M, Financial Management, Vikas Publications, New Delhi, 2000.
- 5 .Shashi k. Gupta , Nisha Aggarwal Neeti Gupta, Financial Institutions and Markets ,Kalyani Publishers,Ludhiana ,2016

Compiled by- Dr Kavita Saxena
Dept of Economics
D.N. College,
Meerut

Disclaimer: This study material is made only for better understanding of the concerned topic for the students. Its use is not permissible for any other purpose.