Paper

Financial Institutions and Markets

M.A. 3rd semester

INTRODUCTION TO FINANCIAL SYSTEM (Part II)

Role of financial system in economic development of a country

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

- **Savings-investment relationship**

To attain economic development, a country needs more investment and production. This can happen only when there is a facility for savings. As, such savings are channelized to productive resources in the form of investment. Here, the role of financial institutions is important, since they induce the public to save by offering attractive interest rates. These savings are channelized by lending to various business concerns which are involved in production and distribution.

- **Financial systems help in growth of capital market**

Any business requires two types of capital namely, fixed capital and working capital. Fixed capital is used for investment in fixed assets, like plant and machinery. While working capital is used for the day-to-day running of business. It is also used for purchase of raw materials and converting them into finished products.

- **Fixed Capital** is raised through capital market by the issue of debentures and shares. Public and other financial institutions invest in them in order to get a good return with minimized risk.

- **For working capital**, we have money market, where short-term loans could be raised by the businessmen through the issue of various credit instruments such as bills, promissory notes, etc.

- **Foreign exchange market** enables exporters and importers to receive and raise funds for settling transactions. It also enables banks to borrow from and lend to different types of customers in various foreign currencies. The market also provides opportunities for the banks to invest their short term idle funds to earn profits. Even governments are benefited as they can meet their foreign exchange requirements through this market.

- **Government Securities market**

Financial system enables the state and central governments to raise both short-term and long-term funds through the issue of bills and bonds which carry attractive rates of interest along with tax concessions. The budgetary gap is filled only with the help of government securities market. Thus, the capital market, money market along with foreign exchange market and government securities market enable businessmen, industrialists as well as governments to meet their credit requirements. In this way, the development of the economy is ensured by the financial system.

- **Financial system helps in Infrastructure and Growth**

Economic development of any country depends on the infrastructure facility available in the country. In the absence of key industries like coal, power and oil, development of other industries will be hampered. It is here that the financial services play a crucial role by providing funds for the growth of infrastructure industries. Private sector will find it difficult to raise the huge capital needed for setting up infrastructure industries. For a long time, infrastructure industries were started only by the government in India. But now, with the policy of economic liberalization, more private sector industries have come forward to start infrastructure industry. The Development Banks and the Merchant banks help in raising capital for these industries.

- **Financial system helps in development of Trade**

The financial system helps in the promotion of both domestic and foreign trade. The financial institutions finance traders and the financial market helps in discounting financial instruments such as bills. Foreign trade is promoted due to per-shipment and post-shipment finance by commercial banks. They also issue Letter of Credit in favor of the importer. Thus, the precious foreign exchange is earned by the country because of the presence of financial system. The best part of the financial system is that the sellers or the buyers do not meet each other and the documents are negotiated through the bank. In this manner, the financial system not only helps the traders but also various financial institutions. Some of the capital goods are sold through hire purchase and installment system, both in the domestic and foreign trade. As a result of all these, the growth of the country is speeded up.

- **Employment Growth is boosted by financial system**

The presence of financial system will generate more employment opportunities in the country. The money market which is a part of financial system provides working capital to the businessmen and manufacturers due to which production increases, resulting in generating more employment opportunities. With competition picking up in various sectors, the service sector such as sales, marketing, advertisement, etc., also pick up, leading to more employment opportunities. Various financial services such as leasing, factoring, merchant banking, etc., will also generate more employment. The growth of trade in the country also induces employment opportunities. Financing by Venture capital provides additional opportunities for techno-based industries and employment.

- **Venture Capital**

There are various reasons for lack of growth of venture capital companies in India. The economic development of a country will be rapid when more ventures are promoted which require modern technology and venture capital. Venture capital cannot be provided by individual companies as it involves more risks. It is only through financial system, more financial institutions will contribute a part of their investable funds for the promotion of new ventures. Thus, financial system enables the creation of venture capital.

- **Financial system promote balanced growth**

Economic development requires a balanced growth which means growth in all the sectors simultaneously. Primary sector, secondary sector and tertiary sector require adequate funds for their growth. The financial system in the country will be geared up by the authorities in such a way that the available funds will be distributed to all the sectors in such a manner, that there will be a balanced growth in industries, agriculture and service sectors.

- **Financial system helps in fiscal ground and control of economy**

It is through the financial system, that the government can create a congenial business atmosphere so that neither too much of inflation nor depression is experienced. The industries should be given suitable protection through the financial system so that their credit requirements will be met even during the difficult period. The government on its part can raise adequate resources to meet its financial commitments so that economic development is not hampered. The government can also regulate the financial system through suitable legislation so that unwanted or speculative transactions could be avoided. The growth of black money could also be minimized.

- **Financial system's role in balanced regional development**

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

- **Role of Financial System in attracting foreign capital**

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

- **Financial system's role in Economic Integration**

Financial systems of different countries are capable of promoting economic integration. This means that in all those countries, there will be common economic policies, such as common investment, trade, commerce, commercial law, employment legislation, old age pension, transport co-ordination, etc. We have a standing example of European Common Market which has gone to the extent of creating a common currency, representing several countries in Western Europe.

- **Role of financial system in Political stability**

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

- **Financial system helps in Uniform interest rates**

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

- **Financial system role in Electronic development:**

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

Functions of financial system

- **Pooling of Funds:** In a financial system, the Savings of people are transferred from households to business organizations. With these production increases and better goods are manufactured, which increases the standard of living of people.
- **Capital Formation:** Business requires finance. These are made available through banks, households and different financial institutions. They mobilize savings which leads to Capital Formation.
- **Facilitates Payment:** The financial system offers convenient modes of payment for goods and services. New methods of payments like credit cards, debit cards, cheques, etc. facilitate quick and easy transactions.
- **Provides Liquidity:** In the financial system, liquidity means the ability to convert into cash. The financial market provides the investors the opportunity to liquidate their investments, which are in instruments like shares, debentures, bonds, etc. Price is determined on the daily basis according to the operations of the market forces of demand and supply.
- **Short and Long-Term Needs:** The financial market takes into account the various needs of different individuals and organizations. This facilitates optimum use of finances for productive purposes.
- **Risk Function**: The financial markets provide protection against life, health, and income risks. Risk Management is an essential component of a growing economy.
- **Better Decisions:** Financial Markets provide information about the market and various financial assets. This helps the investors to compare different investment options and choose the best one. It helps in decision making in choosing portfolio allocations of their wealth.
- **Finances Government Needs:** The government needs a huge amount of money for the development of defence infrastructure. It also requires finance for social welfare activities, public health, education, etc. This is supplied to them by financial markets.
- **Economic Development:** India is a mixed economy. The Government intervenes in the financial system to influence macroeconomic variables like interest rate or inflation. Thus, credits can be made available to corporate at a cheaper rate. This leads to the economic development of the nation.

Main Functions of Financial System:

- The functions of the financial system can be enumerated as follows:
- The financial system acts as an effective conduit for optimal allocation of financial resources in an economy.
- It helps in establishing a link between savers and investors.
- The financial system allows ‘asset-liability change’. When they accept deposits from customers, banks make claims against themselves, but they also make assets when providing loans to customers.
- Economic resources (i.e., money) are transferred from one party to another through the financial system.
- The financial system ensures the efficient functioning of the payment mechanism in the economy. All transactions between buyers and sellers of goods and services are easily affected due to the financial system.
- In the case of mutual funds, the financial system helps in risk change by diversification.
- The financial system increases the liquidity of financial claims.
- The financial system helps in finding the prices of financial assets from the
- Contact of buyers and sellers. For example, the value of the securities is determined by capital market demand and supply forces.
- The financial system helps reduce the cost of transactions.

As discussed above, financial markets play an important role in economic development through the role of capital allocation capital, supervising managers, saving savings and promoting technological change among others. Economists had thought that the development of the financial sector is an important element to encourage financial growth.

Financial development can be defined as the ability to obtain information effectively in the financial sector, implement contracts, facilitate transactions, and promote special types of financial contracts, markets, and arbitrators should be at a lower cost.

Financial development occurs when financial tools, markets, and intermediaries improve on the basis of information, enforcement and transaction costs, and therefore provide better financial services. Financial work or services can affect the economy’s savings and investment decisions through capital accumulation and technical innovation and therefore economic growth.

Capital accumulation can be modelled either through capital peripherals or capital goods, which are produced using constant returns, but without the use of any reproduction factors to stabilize static per-state growth.

Through capital accumulation, the steady growth rate in the work done by the financial system affects the rate of capital formation. The financial system affects capital accumulation either by either changing the savings rate or by reallocating the savings between capital production levels.

Through technological innovation, focus on innovation of new production processes and inventions.

Because friction of the market and laws, rules and policies are quite different with the economies and the times, the impact of financial development on development can have different effects for the economy allocation and welfare in the economy.

Functions of Financial System:

Some other functions are:-

The financial system helps production, capital accumulation, and growth by 1) encouraging savings, 2) mobilizing them 3) allocating them among alternative uses and users. Each of these functions is important and the efficiency of a given financial system depends on how well it performs each of these functions.

1. **Encourage Savings:**
   Financial system promotes savings by providing a wide array of financial assets as stores of value aided by the services of financial markets and intermediaries of various kinds. For wealth holders, all this offers ample choice of portfolios with attractive combinations of income, safety and yield.
   With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is directly related to both financial assets and financial institutions. That is, financial progress generally insures larger savings out of the same level of real income.
2. **Mobilisation of Savings:** Financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instance, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings.

3. **Allocation of Funds**: Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. With modem financial development and new financial assets, institutions and markets have come to be organised, which are replaying an increasingly important role in the provision of credit.

CONCLUSION

The Indian financial system has undergone structural transformation over the past decade. The financial sector has acquired strength, efficiency and stability by the combined effect of competition, regulatory measures, and policy environment. Competition, consolidation and convergence have been recognized as the key drivers of the banking sector in the coming years.

Financial system plays a significant role in the economic development of a country. Financial markets present three major efficiencies for the sake of development and they are allocation, information, and operational efficiency. Financial institutions are profit maximizing businesses that earn profits by acquiring funds at interest rates lower than they earn on their assets.

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