



## ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

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### **Construct of the Case**

This case aims to discuss elaborately the Financial System, its role in economic development and structure of Indian Financial System in particular. Author has used exploratory method of research to build this academic case with the extensive usage of web information and books on the Indian Financial System. Financial System is the backbone of any economy and is the key factor for socio-economic development. This case outlines role of financial system via economic development of India. Case begins with the introduction, followed by tracing of Indian Financial System history via Indian Economy and Lastly the Indian Financial System in brief; it ends with questions to be discussed post perusing the case.

### **Introduction of the Case**

The Indian Economy is third-largest by purchasing power parity (PPP) and seventh-largest in the world measure by nominal GDP. The country is classified as a newly industrialised country, and one of the G-20 major economies, with an average growth rate of approximately 7% over the last two decades. India's economy became the world's fastest growing major economy in the last quarter of 2014, surpassing the People's Republic of China. According to the IMF, India's growth is expected to 7.2% in the 2017–18 fiscal and 7.7% in 2018–19. (WIKIPEDIA, 2017)

India was governed conservatively after the end of British occupation. The economy was then characterised by extensive regulation, protectionism, public ownership of large monopolies, pervasive corruption and slow growth. Since 1991, continuing economic liberalisation has moved the country towards a market-based economy. By 2008, India had established itself as one of the world's faster-growing economies. For all the above achievements, Indian Financial System has been significant.

### **Tracing the History of Indian Financial System via Indian Economy: (WIKIPEDIA, 2017)**

History traces the trade from as early as first century B.C., initially trades were done through barter system which later got replaced by coins that were issued by the kingdoms and rulers. The Mughal when they ventured in India, they introduced the Mughal economy that functioned on an elaborate system of coined currency, land revenue and trade. After the arrival of British East India Company, it dominated the economy. British territorial expansion in India throughout the 19th century created an institutional environment that, on paper, guaranteed property rights among the colonisers, encouraged free trade, and created a single currency with fixed exchange rates, standardised weights and measures and capital markets within the company-held territories.

Immediately after the independence the country led the economy with British experience with lot of regulations and protectionism. The tycoon J. R. D. Tata, had quoted on the Indian Regulatory System, 1969 that “I cannot decide how much to borrow, what shares to issue, at what price, what wages and bonus to pay, and what dividend to give. I even need the government's permission for the salary I pay to a senior executive.”

Prime Minister Indira Gandhi nationalised 14 banks in 1969, followed by six others in 1980, and made it mandatory for banks to provide 40% of their net credit to priority sectors including agriculture, small-scale industry, retail trade and small business, to ensure that the banks fulfilled their social and developmental goals. Since then, the number of bank branches has increased from 8,260 in 1969 to 72,170 in 2007 and the population covered by a branch decreased from 63,800 to 15,000 during the same period. The total bank deposits increased from 59.1 billion (US\$920 million) in 1970–71 to 38,309.22 billion (US\$590 billion) in 2008–09. Despite an increase of rural branches – from 1,860 or 22% of the total in 1969 to 30,590 or 42% in 2007 – only 32,270 of 500,000 villages are served by a scheduled bank.

The Narasimha Rao government, including Finance Minister Manmohan Singh, initiated economic reforms in 1991. By the turn of the 21st century, India had progressed towards a **free-market economy**, with a substantial reduction in state control of the economy and **increased financial liberalisation**. While the **credit rating** of India was hit by its nuclear weapons tests in 1998, it has since been raised to **investment level** in 2003 by Standard & Poor's (S&P) and Moody's. India experienced high growth rates, averaging 9% from 2003 to 2007. Growth then moderated in 2008 due to the global financial crisis. In 2003, Goldman Sachs predicted that India's GDP in current prices would overtake France and Italy by 2020, Germany, UK and Russia by 2025 and Japan by 2035, making it the third-largest economy of the world, behind the US and China. India is often seen by most economists as a rising economic superpower which will play a major role in the 21st-century global

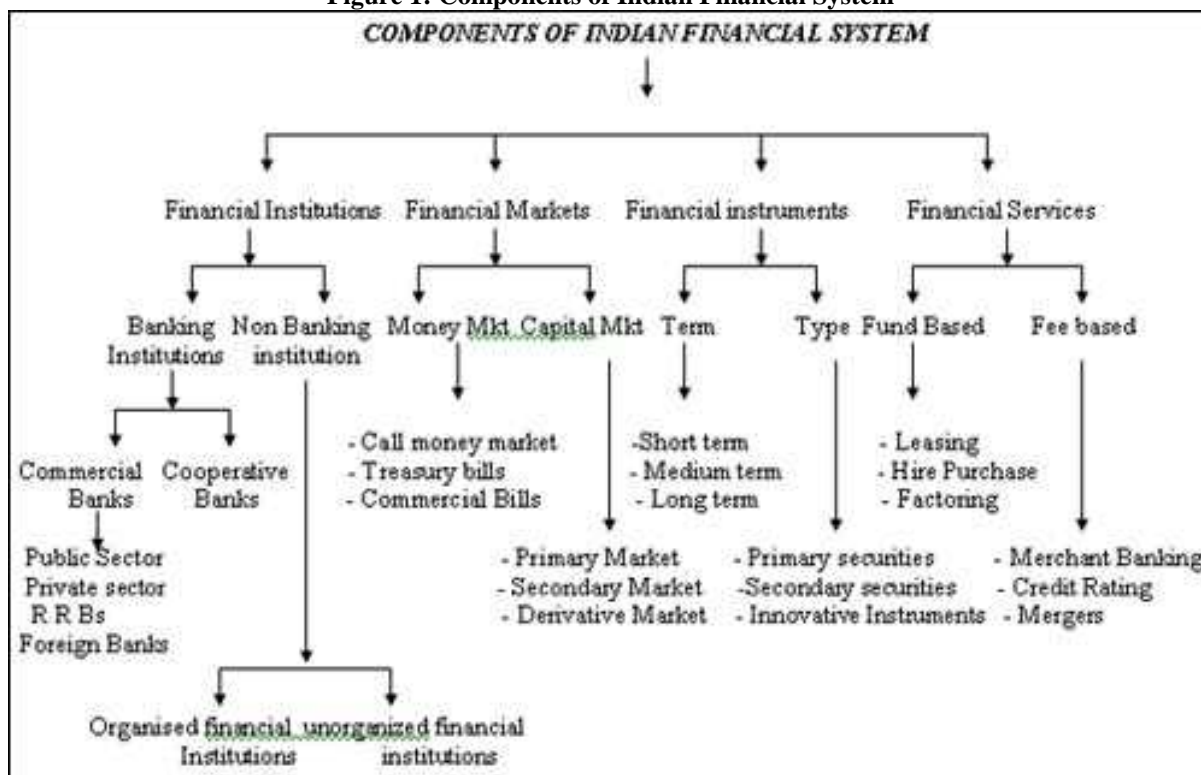
economy. Starting in 2012, India entered a period of reduced growth, which slowed to 5.6%. Other economic problems also became apparent: a plunging **Indian rupee**, a persistent high current account deficit and slow industrial growth. Hit by the US Federal Reserve's decision to taper quantitative easing, foreign investors began rapidly pulling money out of India – though this reversed with the stock market approaching its all-time high. India started recovery in 2014–15 when the growth rate accelerated to 7.2%. In 2015, India went through a startup boom and manufacturing expanded in 2015–16 with growth of 7.6%. For the first time since 1990, India grew faster than China which registered 6.9% growth in 2015. In mid-2015, during the global stock market rout, India witnessed a sharp fall in **stock markets** and the rupee; this repeated again in January 2016.

India's gross domestic savings in 2006–07 as a percentage of GDP stood at a high 32.8%. More than half of personal savings are invested in physical assets such as land, houses, cattle, and gold. The government-owned public-sector banks hold over 75% of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively. Since liberalisation, the government has approved significant banking reforms. While some of these relate to nationalised banks – such as reforms encouraging mergers, reducing government interference and increasing profitability and competitiveness – other reforms have opened the banking and insurance sectors to private and foreign companies.

### The Financial System in India

Unlike in past when financial services sector mainly constituted of banking sector, today financial sector has broadened its reach to include sectors like insurance services, non-banking financial services, co-operatives, pension funds, mutual funds, capital market etc. The figure below illustrates the Indian financial system.

**Figure 1: Components of Indian Financial System**



Source: Google Images.

Financial sector's contribution comes across even more strong when we look at sheer number of employment and tax revenue it generates. Especially employment generated by banking and insurance sector every year runs in millions. Equally revenue generation through tax and dividend collection by the government surpasses billions of rupees every year. While revenue and employment generation are two very important contributions, successfully maintaining healthy credit line to industrial sector as well as to overall economy is another important contribution of financial sector. Banks and non-banks in India have been discharging credit in billions to big, medium/small industries, entrepreneurs etc every financial year. With improved availability of credit, the Indian economy during past two decades has managed to march towards higher economic growth.



Reforms within banking sector during post liberalization era have especially proven to be prudent for credit disbursement in the country. The advent of private sector banks in particular opened a new chapter for Indian economy. The enormous success of private sector banks helped large corporate paving the way for consolidated growth in industrial sector encompassing MSME.

Recent important reforms have made financial sector even robust

Over past few years government has taken many reformative steps to make financial sector even more robust. Although it will take quite a few years to see positive impact of these reforms, there is a general consensus that these reforms will rewrite a chapter in Indian economy. More specifically, these reforms will open new stream of revenue and employment generation for the economy. Listed below are some of these reforms,

1. In 2015, RBI took unprecedented step by opening up the much anticipated 'payment bank' sector. It awarded payment bank licenses to 11 entities. Along with redefining consumer experience, these 11 payment banks are expected to give further boost to growth of financial sector as well as to overall Indian economy.
2. To make banks more 'credit friendly', RBI has allowed banks to raise funds via long-term bonds for financing the critical infrastructure sector. This means banks no longer have to meet cash reserve ratio, statutory liquidity ratio or priority sector norms to disburse credit for big infrastructure projects.
3. In a welcome step, in 2015 Indian government raised the cap of FDI in insurance sector by 49%. Thereby making way for more foreign direct investment in insurance as well as financial sector. Following this decision, many foreign insurance companies operating in India have already raised their stake to 49% in their joint venture with Indian insurance companies.
4. In 2015, Indian government started Mudra Scheme, under which Indian banks will be providing cheap and affordable credit to new & small entrepreneurs.

#### Case in Furtherance

The information pertaining to the contribution of various financial system components i.e. contribution of Mutual Funds, Insurance and other such services had at their introduction and parallel impact on the economy with financial systems evolution can be learned for the case analysis.

#### Questions for Discussion

1. What is the Financial System? What are its functions?
2. Explain the role of Financial System in Economic Development.
3. State the structure and components of Indian Financial System.

**\*Note for Case Analysis and Questions for Discussion:** The readers are suggested to refer the books mentioned in the references for the detailed literature on Indian Financial System.

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