Re-oriented 5th Edition

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The Indian Financial System and Development

Innovating Success

Vasant Desai

Himalaya Publishing House
ISO 9001:2008 CERTIFIED

THE INDIAN FINANCIAL SYSTEM AND DEVELOPMENT

Innovating Success

- Financial System
- Markets
- Intermediaries
- Institutions
- Instruments
- Services

Vasant Desai

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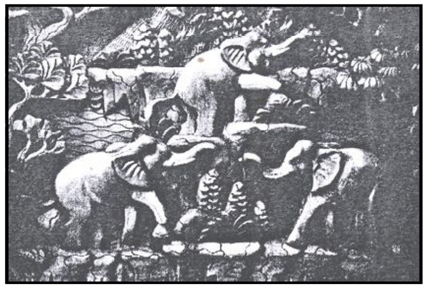
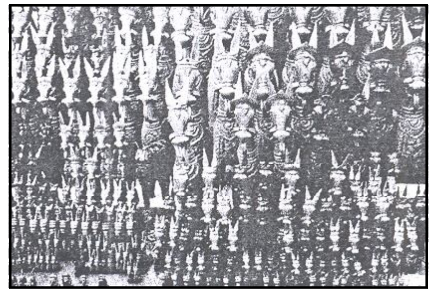
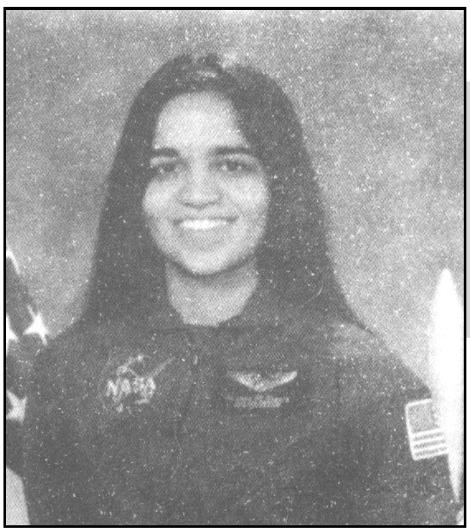



Stars Light the Way



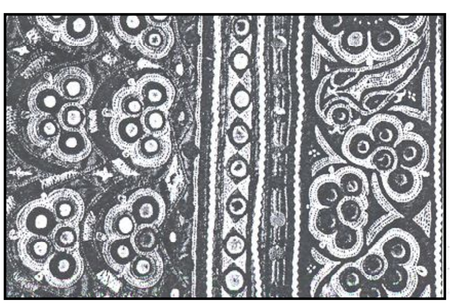
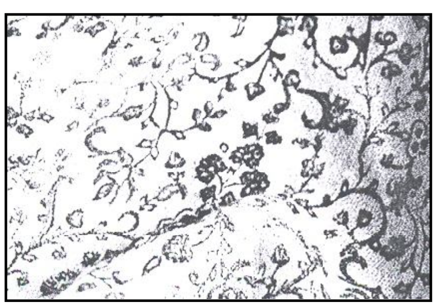
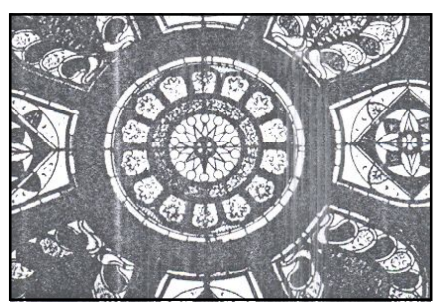
In Loving Memory of

Kalpana Chawla

Mission Specialist (1961-2003)

"None of our astronauts travelled a longer path to space than **Kalpana Chawla**. She left India as a student, but she would see the nation of her birth, all of it, from hundreds of miles above."

One of the meanings of her name was "imagination," or "something nearly impossible to attain." When Kalpana Chawla was a young girl in Karnal, her future brilliant accomplishments as an American astronaut must have seemed fantasy, indeed. Already a role model for young women everywhere, the pride of India as well as America, the intervening years saw her enhance that example. Not only did she persevere on her professional path as an aerospace engineer and pilot, she took pains to encourage young people, every year inviting two children from her hometown to visit her at NASA. She urged them to follow their dreams.

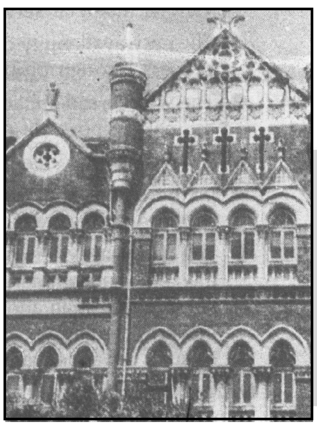




In Search of Leadership

"Leadership is the capacity to frame plans which will succeed and the faculty to persuade others to carry them out in the face of all difficulties."

"Knowledge is like money. To be of value it must circulate and in circulating, it can increase in quantity and hopefully, in value."

LOUIS L'AMOUR



"A good manager is one who gets the maximum from his equipment. A better manager is one who gets the maximum from business. And a far better manager is one who plants seeds of thinking in the minds of his men."

"Growing and developing others is one of management's key responsibilities. The traditional view of management is getting work done through people, but strong leaders develop people through work."

JIM CLEMMER

A true leader is one whose efforts are directed primarily towards the growth of the company and the means of achieving organisational goals.

Conviction and competence are the other traits that define a good leader and contribute to his ability to achieve success for his organisation. While commitment and motivation are generally classified as relative terms, they are instrumental in contributing to a team's success. The leader, on his part, must work towards mastering the art of motivating his team and sustaining its commitment levels, both of which can be very challenging.

A transparent work environment fosters trust and better co-operation amongst team members. Such an environment encourages more interaction between the teams and eventually results in more creative and quality output.

Patience and a practical approach contribute handsomely to the long-term success of the team. True leadership, therefore, is not only about being patient and practical as a leader, but also about instilling these qualities in each team member. It is, after all, not individual effort, but teamwork that ultimately leads to the company's success.

Leaders who think ahead of their times and start their journey at the grass root level are most likely to succeed in their efforts. Dreaming and working towards realising those dreams, however difficult the path may be, is what makes for success as a leader and as a human being.

The Mission

- The objective of all economic activity is to promote the well-being and standard of living of the people, which depends on the income and distribution of income in terms of real goods and services in the economy. The production of output, which is vital to the growth process in the economy, is a function comprising of the many inputs used in the productive process.
- A financial system provides services that are essential in a modern economy.
- Savings mobilisation and promotion of investment are functions of the stock and capital markets which are a part of the organised financial system in India.
- Financial markets are a source of finance and help to foster sounder corporate capital structure.
- Commercial banks will continue to dominate financial system by ensuring the availability of various financial services.
- The easy availability of financial inputs in the form of capital, cash and credit promote the growth process through proper co-ordination between human and material inputs.
- The widespread application of technology has increased the global integration of financial markets by making possible round-the-clock trading, as well as improved its efficiency.
- Innovative instruments have become a major force transforming financial markets.
- Increased financial integration has major implications for the mix of fiscal and monetary policies, as these policies are affected in different ways.
- The financial system needs to take congnisance of the trust building approach to institutionalising markets as a legitimate means of exchange and resource allocation. It is obvious that this approach needs a thorough and an informed debate around the critical aspects of any market-institutions, players, regulation, and information. And, it cannot be over-emphasised that time is of essence in such an endeavour.
- The financial inputs emanate from the financial system, while real goods and services are part of the real system. The interaction between the real system (goods and services) and the financial system (money and capital) is necessary for the productive process. Trading in money and monetary assets constitute the activity in the financial markets and are referred to as the *financial system.*

Money Mantras

Listen to the moneymen. More than anyone else, they know what they're talking about when it comes to making big bucks:

- Keep your financial objectives short and clear.
- Goodwill goes a long way in the creation of wealth.
- Trust is key — without it, there's nothing but a one-off deal.
- Wealth should be put to productive use.
- Financial ethics must be valued.
- Greed alone cannot make you a millionaire.
- Money means responsibility.
- Making money is not a crime. If you use it positively.
- 17 years of liberalisation is not enough.
- Once you make money — respect it and live an honourable life.

SOME RARE COINS COIN NAME: SHAHENSHAH

Minted from pure gold and weighing around 1.1 Kg, this rare coin called Shahenshah, dates back to the period between 1640 and 1650.

The coin has an interesting origin. Khalifa, the head of the Muslim sect had ostracised Islamic kings Akbar, jahangir for minting coins with images of humans or other living beings, as according to the Islamic mandate this was forbidden. Khalifa, who migrated from Baghdad to Morocco, gave a stern warning to Shah Jahan to discontinue this practice. Shah Jahan was one of the most powerful leaders of his times and would have not bowed in front of any one.

So, to please Khalifa, one of Shah Jahan's advisors came up with a solution of minting a large pure gold coin and naming it Shahenshah. This was to be presented to Khalifa with a message reading. The Shasenshah (Emperor) is at your feet asking for forgiveness.

While one side of the coin has a 'kalma' inscribed on it, the other side has the name of the king.

The Khalifa's daughter, who had married an Afghan prince, took this coin with her. The couple's daughter married the prince of Bahawalpur and the coin was sent with her as dowry. Bahawalpur, in Pakistan, was one of the richest states in India. After independence, the daughter of the Bahawalpur prince carried it to London, it was in London that it was auctioned and bought by Mody.

COIN NAME: CHHATRAPATI SHIVAJI MAHARAJ

After conquering the Raigad fort in 1664 Chhatrapati Shivaji Maharaj issued this coin at the time of his coronation. It was denominated as hon and was then given out to the Brahmins. The coin has the words, 'shree raja shiv' inscribed on one side and 'chhatrapati' on the other side.

COIN NAME: RUPIYA

This is the only coin which has the words 'rupiya' inscribed on the top end of the coin. Akbar minted this coin, in around 1600 A.D., as he wanted to standardise the denominations of his coins. Akbar had minted coins of around 18 different denominations like atman, tan, man dhan, damani, daam, charan and many more. These were basically influenced by Hindu Scriptures and also by his wife Jodhabai.

Apart from standardising the denomination to 'rupiya' Akbar also fixed the weight (around 11 grams) and the fixed amount of metal into the alloy (99 per cent silver). It was only the size of the coin that varied.

COIN NAME: ANDAMAN TOKEN

This coin was the currency of the Kalapaani (old name for Andaman and Nicobar Island). The British issued the coin in 1861 from their jail in Kalapaani, where nationalists fighting for Indian independence were jailed for life during their rule. The denomination of this coin was one rupee denomination.

COIN NAME: TWO MOHURS

King William IV issued this Indian coin in 1835. This coin bears the emblem of the Reserve Bank of India, is graded at 65 (note: machine minted coins are graded on a scale of 1 to 70, the higher the grade, greater the value.)

COIN NAME: ONE DOLLAR

Issued by King George VI in 1941, this Indian coin was known as one dollar. This coin had a denomination of two rupees and eight annas. During in India, the British minted coins by the name of dollar in India as well as in London.

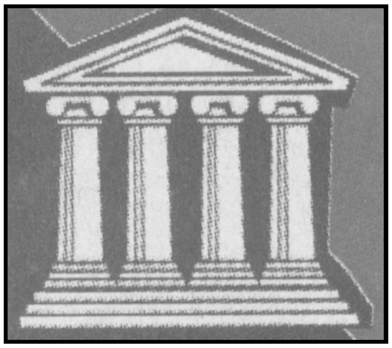
COIN NAME: JAI HIND

This coin was minted by the Madan Singh of Kutch to celebrate Indian Independence in 1947. It is the only coin with the words 'jai Hind' inscribed on it. The denomination of this coin was Kori.

COIN NAME: RAASHI COINS

Jahangir ruler of the Mughal Empire from 1605 to 1627, had issued 12 coins in 1680 A.D. according to the changing constellations. Jahangir who was also a great astronomer, had done this to simplify people's understanding on the varying constellations. Depending on this change, the coins were used by the local. Even today many countries across the word continue to practice this.

PREFACE



Financial System is the mirror reflection of an economy. The performance of any economy to a large extent, is dependent on the performance of the financial institutions. In such an environment the ability to adopt to emerging dynamics is deciding the growth of sound financial system. The rules of the game are on Mergers and Acquisitions. The financial services industry is seeing a consolidation, with all segments of players offering of a plethora of services.

In the post liberalisation era, the finance sector is witnessing a complete metamorphosis. Deregulation measures have included the freeing up of direct controls over ownership, liberalising interest rates and credit allocation, deregulating foreign exchange transaction controls, freeing up the entry of new firms, and expanding and broadening the base of the banking system both for nationals and international business ventures. At the same time, non-banking financial institutions, securities markets and money markets have developed to mobilize and allocate savings. Experience suggests that financial liberalisation needs to be undertaken alongside macro-economic reform.

In this context, **"The Indian Financial System and Development"** is a subject that is assuming greater importance and is bound to be one of the key topics of discussion during the next two/three decades. This is, as it should be, to consider what sort of financial institutions will be best suited to the economic environment in the 21st century. I have immense pleasure in placing the re-oriented fifth edition in your hands this year, 2016. I sincerely thank the students, teachers, professionals and readers for having shown immense interest in this study for all these years.

Redefining the Role

Experience has shown that sustainable economic development needs efficient and innovative financial systems. It provides services that are essential in a modern economy. Financial system plays an important role by mobilising savings and allocating them to the most profitable activities, and enables society to make more productive use of its scarce resources. Conditions that support the development of a more robust and balanced financial structure will improve the ability of domestic financial systems, including strategies to contribute to economic growth.

What is Finance all About?

Finance is about financial decisions. Basically, there are three major financial decisions that companies and investors have to take. These are:

How to invest: This requires an understanding of investment objectives, risk-return characteristics of various assets (e.g., stocks, bonds, annuities and hybrid securities), asset valuation (e.g., capital budgeting and various asset pricing models), and portfolio construction.

How to finance and manage investments: This requires an understanding of how the capital markets work, the benefits and costs of various sources of funds (e.g., debt *vs.* equity), dividend policy, and what financial tools (i.e., derivative securities and insurance) can be used to control risks.

How to manage day-to-day working capital: Requires an understanding of the benefits and costs of holding liquid assets such as cash, inventories and receivables.

The Structure of the Financial System

The financial system consists of many institutions, instruments, and markets. Financial institutions range from paan (betel) shops and moneylenders to banks, pension funds, insurance companies, brokerage houses, investment trusts, and stock exchanges. Financial instruments range from the common — coins, currency notes, and cheques; mortgages, corporate bills, bonds, and stocks — to the more exotic — futures and swaps of high finance. Markets for these instruments may be organised formally or informally.

All the indicators of financial development have significantly increased, implying the growing importance of financial institutions in the economy and growth of financial flows in relation to economic activity, both in the form of direct and indirect finance. As at the end of March 2008, the total assets of all financial institutions, including banks amounted to ₹ 77,60,719 crore, of which, the scheduled banks accounted for ₹ 31,93,358 crore, which amounts to 41.1 per cent of the total. Financial assets of the system have far exceeded the national income as well as aggregate monetary resources.

The Indian Financial System is passing through a period of reforms, structural adjustment and consolidation in the wake of economic liberalisation. And more importantly, the stage is set for starting a phased financial liberalisation programme which needs to be undertaken alongside macro-economic reforms. Financial sector is opening up for expansion, growth and transparency. In the process, the financial system will not only be widened, but also be strategically planned to meet the growing needs of the economy. The decade of nineties holds a promise of further financial growth, diversification, and stability. The fundamental changes in the financial system reflect the responsiveness of the policy makers to meet the ever growing needs of the economy.

Different financial institutions provide services that are both complementary to and competitive with each other. Deposit institutions offer payment and liquid deposit facilities, and contractual savings institutions provide illiquid savings opportunities that cater to the long-term needs of the customers. Collective investment institutions offer small investors the benefits of professional management and low-cost risk diversification, encouraging them to diversify their savings into marketable securities. On the lending side, commercial banks have traditionally provided working capital and trade finance, but long-term lending is gaining a foothold with the spread of universal banking. Factoring companies specialise in financing inventories and receivables, whereas development banks and leasing companies provide long-term investment finances.

Money and capital markets provide investment instruments appropriate for contractual savings and collective investment institutions, whose services to the saving public are thereby improved. Different financial institutions and markets compete for a limited pool savings by offering different instruments, which are complementary in nature.

With the opening up of the economy since the early 1990s, issues relating to the open economy macroeconomics have become more relevant for macroeconomic policy. With financial liberalisation and increasing globalisation, capital movements have come to play an important role in influencing the exchange rate and interest rate arithmetic of the financial markets on a day-to-day basis. The volatile nature of the capital flows triggering instability and the subsequent contagion effect has been demonstrated in various episodes of financial crises across the world during the 1990s. The growing interaction between the fiscal deficits, capital flows, exchange rates and interest rates have posed a number of macroeconomic policy challenges.

In planning for the future, it is important to have a clear and consistent objective for strategically planning finance. The key objective of the financial system is the provision of financial services at prices that reflect their cost. The financial system can also be used in moderation for other objectives. In the past, however, governments of developing countries have tried to do too much — using the financial system to finance the government budget deficit, redistribute income and serve as a tool in implementing their development strategies. Multiple and often conflicting objectives have impaired the financial systems in India.

The Process of Change

India's financial sector is moving towards global benchmarks, with rising efficiency, transparency and dynamism. Broad-based reforms have made the financial sector competitive to support economic growth.

The Indian financial system has undergone substantial changes, in response to the changes that have been taking place in the social, political and economic environment. In addition to meeting the increasing demands from the traditional markets, new markets have been brought into the financial sector, entailing in the process the adoption of new marketing practices and calling for an entirely new approach and a significant change in the market attitudes. And, the financial sector can also claim to have achieved some success in this sphere.

A sound financial system touching every aspect of economic activities is a pre-requisite of a vibrant and developing economy.

The Need for Pragmatic Study

Considering the overwhelming significance of the financial system markets intermediaries, institutions, instruments and services — in the Indian economy and the need to impart a thorough understanding of managerial and operational aspects of financial system in India, different national institutes of management and universities have of late restructured their course curricula to include a separate subject on *'Financial System'* as an optional subject. However, in view of the growing significance of the financial sector, in due course, it will be turned into a compulsory subject. The Indian financial system and development merit a due recognition by all universities in India.

Organisation of the Book

The prime objective of the book is to provide executives, practitioners and management students an insight into the principles, operational policies and practices of the prominent Indian financial institutions which are in the money game and capital markets.

The whole text has been discussed in ***sixty*** chapters, grouped in ***six*** parts.

Part I consists of ten chapters and focusses on the macro-economic environment that has confronted the Indian financial system, its structure, its role and its dimensions. It also discusses analytically the key issues of the financial system. It argues that finance matters in more ways than might be immediately apparent. Efficient financial systems help to allocate resources to their best uses and are indispensable in complex, modern economies.

Varied financial markets are discussed in nine chapters of **Part II**. Money markets provide a flexible means for managing liquidity, a benchmark for market-based interest rates, and an instrument of monetary policy. Capital markets are a source of long-term finance — both debt and equity — and help to foster sounder corporate capital structures. In the nineties, the organised money markets have emerged as a backbone of the Indian vibrant economy.

Part III deals with key market intermediaries of growing importance. It consists of ten chapters.

Part IV deals with financial institutions and their structure, functioning in the changing economic scenario. The deepening and spreading of the financial system throws light on its diversity and innovations. It consists of ten chapters.

Part V discusses different financial instruments in eleven chapters. The financial instruments cater especially to the growing needs of the economy.

Part VI deals with the financial services in nine chapters. The financial services play a crucial role in driving the economy.

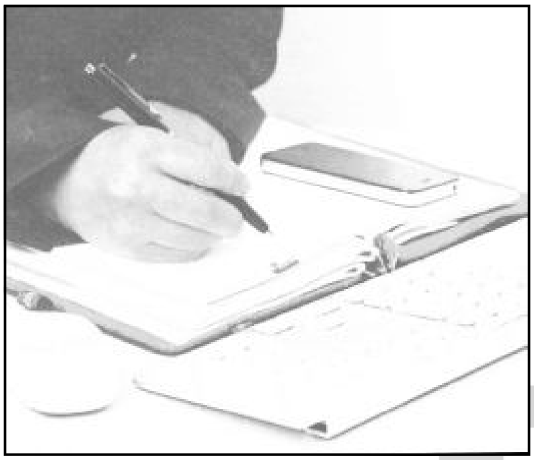
During the ten years the Indian financial systems has undergone a sea of changes in keeping with the world economics. Yet the Indian financial system has emerged stronger inspite of the world financial crisis. the study also has become more relevant in todays changing scenerio. The support this study received is quite encouraging and inspiring.

The book provides an insight into the financial system and its unique role in the economy. In short, the study acts as a motivator to pursue a career in the growing and innovative financial system.

I hope that the voluminious study greatly enhance the understanding of the Indian financial sector among a wide readership both in India and abroad. I would earnestly urge the students teachers and regulatory agents to promote wide dissemination and debate and initiate policy actions for improving the structural aspects of the Indian financial architecture.

I shall feel duly rewarded, in meeting the needs of students squarely as well as in arousing adequate interest in the minds of readers and students on the important multi-dimensional facets of the Indian financial system and assess its contribution to economic development and growth.

Acknowledgements



My debt to those who have helped me in one way or the other is worth appreciating. While I take this opportunity to thank all of them — they are too numerous to mention individually in a brief preface — I would like to acknowledge my deep sense of gratitude to Mr. K.N. Pandey, Mr. Anuj Pandey, Mr. Niraj Pandey, Ms. Phalguni Ravi and M.V. Desai for their co-operation at all stages.

I take this opportunity to express my sincere appreciation and gratitude to Mrs. Ina Jadhav for reading the book carefully and suggesting changes to make it more crisp, lucid and informative. If the book spontaneously arouses the attention of the students, entrepreneurs, faculty members of entrepreneurial studies, policy makers and researchers, the credit naturally goes to her for her studied help in presenting a new book in a newer format.

I also take this opportunity to express my sincere thanks to Mrs. Sunanda Jagdale for designing the book in a new format, Mrs. Ina Jadhav for careful reading, Mrs. Archana Gupte for coordinating the study and Mr. Bahadur Karki for his logistic support with their active support I am presenting this re-oriented valuable edition to the new batch of teachers, students and others interested in finance.

No words can adequately express my debt of gratitude to my late father, Shri Ranganath Balawant Mutalik Desai (1909-2006) and my late mother Smt. Laxmidevi (1914-2000), for generating in me a perennial interest in higher studies.

I am particularly indebted to my wife, Mandaramala, whose patience, support, encouragement, understanding, and love helped this effort to fruition.

Finally, I thank all those who directly or indirectly helped me in bringing out this unique and re-oriented study on time.

Mumbai **VASANT DESAI**

May 14, 2016

CONTENTS

Part IV : Financial Institutions

Part V : Financial Instruments

Part VI : Financial Services

Salient Features of the Indian Financial System

The financial system of a country is like the circulatory system of a human body, controls the health of the economy and growth of business and society, through the circulation of money. A healthy economy needs an efficient financial system.

Broadly, the financial system comprises of banking, insurance, development finance, universal banking, specialised financial agencies, mutual funds, venture capital funds, stock market leasing and hire purchase, chit funds, nidhis saving agencies, post office, factoring, housing finance, non-banking finance companies, financial consultancy, credit rating, corporate finance and other related sectors. Thus, the financial system is the back-bone of the economy.

The financial system, like any other system, is to be controlled by a well defined and designed mechanism that should ensure smooth functioning, flexible operative methods and an efficient human resource pool to handle the system. The last is the most critical because the quality of the system does not ensure better results unless the human factor is capable, efficient and honest.

Finance is managing money now to go and use it to achieve the best possible returns. It implies earning revenues by raising financial resources through various methods, planning its use, designing methods of paying back the borrowed money and interest on it, and above all, ensuring good profits on all business operations.

Technical skill is the ability to use the appropriate financial tools and techniques, procedures and systems, methods and practices. Human skill is the ability to work with other individuals and groups. You must demonstrate the ability to work, and later lead a group of people, called “a team”. Conceptual skill is the mental ability to coordinate and integrate all of the organisation’s interests and activities.

Financial Stability

Since financial stability poses a severe threat to important macro-economic objectives, there is a greater need for it. The term financial stability broadly describes steady state in which the financial system efficiently performs its key economic functions. Financial stability as the prevalence of a financial system, which is able to ensure in a lasting way an efficient allocation of savings to investment opportunities maintenance of a level of confidence in the financial system amongst all the participants and stakeholders and absence of excessive volatility that unduly and adversely affect real economic activity. Well developed precautionary measures help in maintaining financial stability of the economy. These include development of a set of standards and codes, prudential regulation, early warning signals, supervision of financial intermediaries, compliance with international standards as regards capital adequacy norms, asset classification procedures and methods, income recognition principles, market valuation of assets and recovery mechanisms, regular auditing and enforcement of rules and regulations.

The importance of financial stability emanates from four major trends in the financial systems, which have become evident in recent years. These are: (I) an imbalance of growth between the financial sector and the real economy; (ii) a change in the mode of financial operations due to financial deepening (credit/debit cards, etc): (iii) emergence of a globally integrated financial system: and (iv) an evolution of sophisticated financial instruments and attendant risks. Consequently, the sources of crises have multipiled, necessitating the coordination of a number of authorities both within and outside the country.

Financial System Procyclicality

Financial system procyclicality can be traced to two fundamental sources. The first source it limitations in risk measurement. Measures of risk and the assumptions underlying risk measurement practices tend to be highly procyclical. Near-horizon estimates of quantitative inputs such as short-term volatility, asset and default correlations, probabilities of default and loss given default all move procyclically.

The second source is distortions in incentives. Collateral-based lending or margin requirements can protect lenders and traders from actions taken by counterparties that could erode the value of their claims. But by establishing a direct link between asset valuations and funding, fluctuations in margin requirements can exacerbate procyclicality.

Alongside limitations in risk measurement and distortions in incentives, change in accounting norms like moving away from historical-cost based accounting to fair value accounting may add to procyclicality by making valuations more sensitive to the economic cycle, which may in turn have a procyclical impact on risk-taking decisions based on these valuations.

To the extent that financial regulation contributes to procyclicality and excessive risk-taking, supervisors could design their policies in a counter-cyclical fashion to reduce procyclical behaviour of financial institutions. A report from Financial Stability Board (FSB) made recommendations in three key areas: capital regulation, loan loss provisioning, and leverage especially the financial sector, and valuations.

Ensuring an acceptable degree of financial stability is a never ending process. The task for all involved in ensuring financial stability is to remain alert and proactive during tranquil periods, to identify and monitor newer risks, eschew harmful incentives and adjust the regulatory environment to keep abreast with fast-paced changes in the economic environment, particularly in the financial sector.

Financial Market Integration

Integration of financial markets is a process of unifying markets and enabling convergence of risk-adjusted returns on the assets of similar maturity across the markets. The process of integration is facilitated by an unimpended access of participants to various market segments. Financial markets all over the world have witnessed growing integration within as well as across boundaries, spurred by deregulation, globalisation and advanced information technology. Integrated financial markets assume vital importance for the following reasons:

- Integrated markets serve as a conduit for authorities to transmit important price signals.
- Efficient and integrated financial markets constitute an important vehicle for promoting domestic savings, investment and economic growth.
- Fosters the necessary condition for a country's financial sector to emerge as an international or a regional financial centre.
- By enhancing competition and efficiency of intermediaries in their operations and allocation of resources contribute to financial stability.
- Lead to innovations and cost-effective intermediation improves access to financial services for members of the public, institutions and companies.
- Induce market discipline and information efficiency, and
- Promotes the adoption of modern technology and payment systems to achieve cost-effective financial intermediation services.

Financial Inclusion

Financial inclusion refers to delivery of banking services at an affordable cost to the vast selections of disadvantaged and low-income groups who tend to be excluded from the formal banking channel. Despite widespread expansion of the banking sector during the last three decades, a substantial proportion of the households, especially in rural areas, is at present outside the coverage of the formal banking system. The Reserve Bank's board approach to financial inclusion aims at 'connecting people' with the banking system and not just credit dispensation; giving people access to the payments system; portraying financial inclusion as a viable business model and opportunity. Efforts towards 'financial inclusion' include sensitising the banks to the banking and financial needs of the common person and ensuring access to basic banking facilities. In consonance with the above approach, the Reserve Bank has undertaken a number of measures in recent years from attracting the financially excluded population into the formal financial system.

Introduction of 'zero balance' or 'no frills' accounts has enabed the common person to open bank account. However, providing banking facilities closer to the customer, especially in remote and unbanked areas, while keeping transaction costs low, remains a challenge. This has to be done with affordable infrastructure and low operational costs with the use of appropriate techonology. Pursuant to the announcement banks were urged to scale up their financial inclusion efforts by utilising appropriate technology, while ensuring that the solutions developed are: (i) highly secure; (ii) amenable to audit; and (iii) follow widely accepted open standards to allow interoperability among the different systems adopted by different banks. Banks have initiated pilot projects utilising smart cards/mobile technology to increase their outreach. Biometric methods for uniquely identifying customers are also being increasingly adopted.

In this context, financial literacy efforts are expected to enhance access to the financial system by increasing awareness. Banks need to appreciate that transactions will happen if account holders have a stake in the accounts which will arise only when a variety of banking services, including entrepreneurial credit like Kisan Credit Card/ General Credit Card, an overdraft for consumption needs, direct benefit transfers and other remittance facilities are provided. Business and delivery models for providing these and other financial services need to be evolved and implemented.

Technology has the potential to act as a force multiplier in efforts for financial inclusion. There is, however, also an increasing realisation that mere reliance on technology-enabled non-face to face channels alone will not be sufficient to meet the goal of creating an inclusive financial system. Whereever feasible and viable, banks may consider opening more brick and mortar outlets as delivery points, both as a control mechanism for BCs and to gain the trust and acceptability of the financially excluded segment of the population.

Financial Globalisation

The financial globalisation is a key determinant for growth and stability. The more developed a country's financial sector, the greater the growth benefits of capital inflows and the lower the country's vulnerability to crises.

- It has a positive effect on micro-economic stability
- Institutional quality play an important role determining financial integration
- Sound fiscal and monetary policies increase the growth benefits in capital account liberalisation and help avert crises in countries open capital accounts.
- Trade integration improves the cost-benefit trade-off associated with financial integration
- Financial globalisation brings in innovative products, practices in operation
- New technology will bring in greater growth benefits

The process regulation and supervision in India has to be sharpened and diversified to ensure financial stability and maintain confidence in the financial system by enhancing the soundness and efficiency.

Regulation and Supervision

Regulation and supervision of the financial system has received renewed focus in recent years in the context of the phenomenal expansion of the financial sector, technology-enabled innovations in financial products and deepening of global integration. The strategic importance of the banks in the financial system make it imperative for the central bank – historically, the lender of the last resort and the supervisor of the banking system – to pursue financial stability as an important macroeconomic objective, although, in India, there are separate institutions, (viz., the SEBI the PERDA and the IRDA) to oversee the functioning of individual segments of the financial system. A number of initiatives have been taken by the Reserve Bank in reorienting the supervisory and regulatory framework and aligning it with the international best practicies while providing sufficient flexibility to the financial institutions to respond to the growing competition and the regultory and supervisory process in India at the current juncture is at an exciting phase and is progressing towards further maturity aiming to impart greater strength and stability to the financial system. Therefore, the legitimate question to be posed at this juncture is 'from here to where'? it would be useful to identify the factors that may affect the functioning of the Indian banking system in the short, medium and long-term. Accordingly, the regulatory focus and the supervisory processes would need to be altered in some areas and fine-tuned in some other areas in the light of the challenges identified.

Financial systems worldwide are still evolving and the Indian financial systems is not an exception. Rapid growth of computer and telecommunications technology would continue to transform the Indian financial sector. Financial innovations have been the driving force behind the blurring of distinctions among what were, traditionally, very distinct forms of financial firms. In recognition of the new market realities and progression towards universal banking, appropriate legal and regulatory changes would need to follow. The deregulation and liberalisation process is likely to get further expedited. Regulatory response in India has already been focused on promoting a financial system, which is based in market principles.The economic rationale for banking sector consolidation in India is unquestionable at the persent juncture. The character of the ownership is undergoing change away from a predominantly government ownership. The regulatory response, against this backdrop, could be to pay a role of facilitator while leaving the marketforces to decide the extent and content of the consolidation process.

PART-I

FINANCIAL SYSTEM

- The System
- Structure
- Evolution
- Development
- Dimensions
- Functions
- Funds-Flow
- Reforms

Financial System

The financial system consists of many institutions, instruments, and markets. Financial institutions range from pawnshops and moneylenders to banks, pension funds, insurance companies, brokerage houses, investment trusts and stock exchanges. Financial instruments range from the common — coins, currency notes, and cheques; mortgages, corporate bills, bonds, and stocks — to the more exotic — futures and swaps of high finance. Markets for these instruments may be organized formally (as in stock or bond exchanges with centralized trading floors) or informally (as in over-the-counter or curb markets). The financial system provides services that are essential in a modern economy. It is a core factor of development and growth. The primary role of any financial system is to act as a conduit for the transfer of financial resources from net savers to borrowers, i.e., from those who spend less than they earn to those who earn less than what they spend.

The economic development of a country depends, inter alia, on its financial structure. In the long run, the larger the proportion of financial assets to real assets, the greater the scope for economic growth. Investment is a pre-condition of economic growth. This apart, to sustain growth, continued investment in the growth process is essential. Since finance is an important input in the growth process, it has a crucial role to play in the economy. The more efficient composition of real wealth is obtained by the promotion of financial assets which provide incentives to savers to hold a large part of their wealth in financial form. The increasing rate of saving is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

Historically, financial systems in emerging market and developing economies have been dominated by their banking systems. Excessive reliance on the banking system, however, makes the financial system vulnerable to shocks and exacerbates the crises, as was observed during the East Asian crisis. Developed capital markets also enable countries to reduce their reliance on foreign borrowing. This is particularly important for emerging market countries. Since external debt has been a major source of vulnerability in EMEs, capital market development could potentially exercise a stabilising influence (Rato, 2006). Similarly, complementary or supporting infrastructure such as the repo market, margin trading and derivatives, if developed within an appropriate framework in EMEs, can be important means of reducing the transaction cost further. It also allows market participants to manage and transfer risks to those who are able and willing to bear them, which helps in developing a robust financial system.

The financial system in India has also been dominated by financial intermediaries, in general, and banking institutions, in particular. This pattern has remained more or less unaltered over the years. Households invest only a small portion of their savings in the securities market directly or indirectly through mutual funds. The need, therefore, is felt to develop a diversified financial system over a period of time in which both financial institutions and financial markets play important roles.

Financial sector reforms have had a profound effect in terms of aiding growth, while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system (Reddy, 2000). Although various segments of the financial market, in general, have certainly become deeper and more liquid, there is still some way to go before all the segments of the financial market are fully developed. Whereas it has always been the endeavour of the authorities to develop financial markets the need for developed financial markets has never been so strongly felt as at this point of time. The need for sustaining higher economic growth, improving the transmission mechanism of monetary policy, developing a diversified financial system, maximising the gains from financial integration and minimising its costs, and preparing for smooth capital account convertibility.

CHAPTER 1

THE FINANCIAL SYSTEM: AN OVERVIEW

INTRODUCTION

A well functioning financial system is a *sine qua non* for the pursuit of economic growth with stability. The core of a well developed financial system is to facilitate smooth and efficient allocation of resources from savers to the ultimate users. An efficient financial system is a key to socio-economic development. According to Levine (1997), financial services affect economic growth through five main channels *viz.,* saving mobilisation, resource allocation, risk management, management monitoring and trade facilitation. Each of the five main channels contributes to both capital accumulation and the process of technological innovation.

For years, the Indian financial system was caught in the vise of narrow, inflexible regulations that made it tough to manoeuvre. In a market where everyone was equally handicapped, individual institutions had little chance or reason to excel. Interest rates were regulated for both deposits and lending. Real change started when RBI governor R.N. Malhotra kicked off a gradual deregulation in 1988. Suddenly, things have changed. In a rare burst of innovation, the RBI has taken some major policy initiatives to liberalise the over-regulated financial markets. Short-term interest rates on call money, bill rediscounting, and even cash credit have been freed. New instruments for short-term trading like commercial paper and certificates of deposit have been introduced without any restrictions on the interest rates or the number of participants.

The economic scene in the post-independence period has seen a sea change; the end result being that the economy has made enormous progress in diverse fields. There has been a quantitative expansion as well as diversification of economic activities. The experiences of the 1980s have led to the conclusion that to obtain all the benefits of greater reliance on voluntary, market-based decision-making, India needs efficient financial systems.

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 it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

FINANCIAL SYSTEM

The financial system of a country is like the circulatory system of a human body, controls the health of the economy and growth of business and society, through the circulation of money. A healthy economy needs an efficient financial system.

The financial system consists of many institutions, instruments, and markets. Financial institutions range from pawnshops and moneylenders to banks, pension funds, insurance companies, brokerage houses, investment trusts and stock exchanges. Financial instruments range from the common — coins, currency notes and cheques; mortgages, corporate bills, bonds and stocks — to the more exotic — futures and swaps of high finance. Markets for these instruments may be organized formally (as in stock or bond exchanges with centralized trading floors) or informally (as in over-the-counter or curb markets). The financial system provides services that are essential in a modern economy. It is a core factor of development and growth. The primary role of any financial system is to act as a conduit for the transfer of financial resources from net savers to borrowers, i.e., from those who spend less than they earn to those who earn less than what they spend.

The economic development of a country depends, *inter alia,* on its financial structure. In the long run, the larger the proportion of financial assets to real assets, the greater the scope for economic growth. Investment is a pre-condition of economic growth. This apart, to sustain growth, continued investment in the growth process is essential. Since finance is an important input in the growth process, it has a crucial role to play in the economy. The more efficient composition of real wealth is obtained by the promotion of financial assets which provide incentives to savers to hold a large part of their wealth in financial form. The increasing rate of saving is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

The major function of financial institutions, whether short-term or long-term, is to provide the maximum financial convenience to the public. This may be done in three ways:

(*i*) Promoting the overall savings of the economy by deepening and widening the financial structure;

(*ii*) Distributing the existing savings in a more efficient manner so that those in greater need, from the social and economic point of view, get priority in allotment;

(*iii*) Creating credit and deposit money and facilitating the transactions of trade, production and distribution in furtherance of the economy.

For years, the Indian financial system was caught in the narrow, inflexible regulations that made it tough to manoeuvre. In a market where everyone was equally handicapped, individual institutions had little chance or reason to excel. Interest rates were regulated for both deposits and lending. Real change started when RBI governor R.N. Malhotra kicked off a gradual deregulation in 1988. Suddenly, things have changed. In a rare burst of innovation the RBI has taken some major policy initiatives to liberalise the over-regulated financial markets. Short-term interest rates on call money, bill rediscounting, and even cash credit have been freed. New instruments for short-term trading like commercial paper and certificates of deposit have been introduced without any restrictions on the interest rates or the number of participants.

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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 it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

Box 1.1

Why Does Finance Matter?

Financial systems provide payment services. They mobilize savings and allocate credit and they limit price, pool, and trade the risks resulting from these activities. These diverse services are used in varying combinations by households, businesses, and governments and are rendered through an array of instruments (currency, checks credit cards, bonds and stocks) and institutions (banks, credit unions, insurance companies, pawnbrokers, and stockbrokers). A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them.

Financial services make it cheaper and less risky to trade goods and services and to borrow and lend. Without them an economy would be confined to self-sufficiency or barter, which would inhibit the specialization in production upon which modern economies depend. Separating the timing of consumption from production would be possible only by first storing goods. The size of producing units would be limited by the producers' own capacity to save. Incomes would be lower, and complex industrial economies would not exist.

Finance is the key to investment and hence to growth. Providing saved resources to others with more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, however, lending can be both costly and risky. Self-financed investment is 'one way to overcome these difficulties, but profitable investment opportunities may exceed the resources of the individual enterprise. Investment by the public sector is another answer; in this case additional savings are mobilized through the tax system. But excessive centralization brings its own difficulties, especially in gathering the information needed to make sound investments. Efficiency therefore requires a balance among internally generated resources, centrally organized saving and investment, and market-based financial arrangements.

Market-based arrangements are voluntary. As such, they are driven by the desire for profit, tempered by concerns about risk. Competition ensures that transaction costs are held down, that risk is allocated to those most willing to bear it, and that investment is undertaken by those with the most promising opportunities.

Such arrangements may take many forms but tend to mirror an economy's complexity and political orientation. Informal finance, such as loans within families and between friends or from pawnbrokers and moneylenders is still important in many countries. But as economies grow, these arrangements need to be augmented by the services that only formal institutions - commercial banks, collective investment institutions, and capital market - can apply. For example, by transforming the size and maturity of financial assets, formal institutions can mediate between the many small depositors who prefer liquid assets and the few large borrowers who need long-term loans to finance investment. They can provide other useful services too: insurance, hedging (using options and futures contracts), and so on. In a diversified market-based system, governments retain a key role as prudential regulators, because experience has shown that financial markets — essential though they are can be prone to instability and vulnerable to fraud.

Finance and Growth

Malthus predicted that growing populations and fixed amounts of land and other natural resources would ultimately stifle economic growth. But natural resource endowments have declined in importance in most high-income countries.

The biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency.

Finance and Trade

The financial system makes its biggest contribution to growth by providing a medium of exchange. In a barter economy, trade requires a "mutual coincidence of wants." It is therefore limited by the costly search for trading partners. Specialization is discouraged in economies with no medium of exchange, so their productivity is low. Money facilitates specialization by reducing trading costs and linking different markets. The adoption of a standard unit of account serves the same goal.

Finance and Saving

Saving determines the rate at which productive capacity, and hence income, can grow. On an average, the more rapidly growing developing countries have had higher saving rates than the slower growing countries. These rates are influenced by many factors. In analyzing them it is useful to distinguish between the flow of "Saving" and the stock of "savings". Saving will always refer to the flow of real resources that are not consumed in the period under study and that are therefore available for investment. "Savings" will refer to the stock of accumulated saving, or wealth. An increase in the stock of financial assets will be called "financial deepening."

Many factors affect the saving rate, the rate of income growth, the age composition of the population and attitudes toward thrift. The services provided by government, such as social security, can affect saving as can taxes and government deficits. Macroeconomic and political stability affect expectations and thus affect saving. Whether financial variables affect the saving rate is still an open question.

Finance and Investment

The financial system intermediates only part of a country's total investment, because firms and households finance much of their investment directly out of their own saving. Only when investment exceeds saving it is necessary to borrow, just as when saving exceeds investment it is necessary to lend. The financial system's task is to move excess savings into investment, thereby creating credit to facilitate economic development. Finance and corporate sector industrialisation is *sine qua non* for economic progress. More importantly, *"Finance is the life blood of industry."* The corporate sector depends on the financial system for risk, capital, equity, debt, working capital and so on.

All in all, the influence of governments on the financial system is greater than it is visible. Finance does matter in socio-economic development. It is one of the key input.

SUSTAINABLE DEVELOPMENT

Development involves not merely economic change but also social and institutional changes. In many developing and underdeveloped countries, it calls for new sets of values and new concepts of society and government. As a continuous process, it calls for structural adjustments, innovations as well as new institutions to fulfil the aspirations of the people as well as national objectives.

For more than four decades, there has been growing awareness of the development process associated with certain aspects of economic growth. Challenges of persistent poverty, degradation of natural resources are leading to radically new ways of assessing economic development. The direction of global thinking is towards sustainable development.

The Brundtland Commission defined sustainable development as:

"... a process of change in which the exploitation of resources, the direction of investments, the orientation of technological development and institutional change are all in harmony and enhance both current and future potential to meet human needs and aspirations."

The concept of economic development is itself complex, including not only simply growth in total monetary production but also additional concerns for equity, the quality of life and less tangible human aspirations for education, security and aesthetic values.

FINANCING DEVELOPMENT

The economic development depends upon a multiplicity of factors. Amongst these varied factors, the rate of capital formation is one of the most important determinants of the rate of growth of an economy. It is one of the key inputs of development.

The economic development of a country depends, *inter alia*, on its financial structure. In the long run, the larger the proportion of the financial assets to real assets, the greater will be the scope for economic growth. Investment is a precondition of economic growth. To sustain growth, continued investment in the growth process is necessary. Since finance is an important input in the growth process, it plays a crucial role in the economy. A more efficient composition of real wealth is obtained by the promotion of financial assets which provide incentives to savers to hold a large part of their wealth in the financial form. An increasing rate of savings correlates with the increase in the proportion of savings held in the form of financial assets — relative to tangible assets.

A major function of financial institutions, whether short-term or long-term, is to provide the maximum financial convenience to the public. This can be done in the three ways:

(*i*) Promotion of the overall savings in the economy by an authentic widening of the financial structure;

(*ii*) Purveying the existing savings in a more efficient manner so that those in greater need, from the social and economic points of view, get priority in allotment; and

(*iii*) Monetary financial institutions assist by creating credit and deposit money and facilitating transactions in trade, production and distribution in the economy.

The financial sector plays a major role in the mobilisation and allocation of financial savings in the economy and in facilitating funds flow among the various sub sectors. Financial institutions, instruments and the financial markets together act to transfer financial resources from net savers to net borrowers. The resultant gains to the real sector of the economy depend on the efficiency of the financial sector to perform the function of financial intermediation.

MEANING

The word '*system*' stands for a set of bodily organs like composition or concurring in function, a scheme of classification and a method of organisation.

Finance holds the key to all human activities. Finance is the study of money — its nature, creation, behaviour, regulation and administration. So all those activities dealing in finance are organised in a system known as the financial system or financial sector.

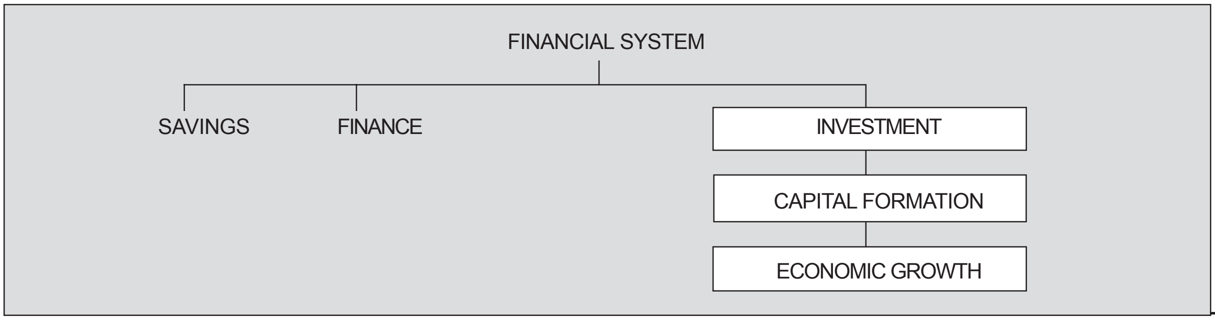


Fig. 1.1 The Concept of the Financial System

THE CONCEPT

The term *financial system* is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment capital formation and growth.

Van Horne defined the financial system as *the purpose of financial markets* to *allocate savings efficiently in an economy to ultimate* users *either for investment in real assets or for consumption*. Christy has opined that 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 utilisation of resources without the destabilising consequence of price 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."*

From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating 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. Thus, financial management is an integral part of the financial system. On the basis of the empirical evidence, Goldsmith said that "... a case for the hypothesis that the separation of the functions of savings and investment which is made possible by the introduction of financial instruments as well as enlargement of the range of financial assets which follows from the creation of financial institutions increase the efficiency of investments and raise the ratio of capital formation to national production and financial activities and through these two channels increase the rate of growth...."

Thus, the inter-relationship between varied segments of the economy are illustrated below:

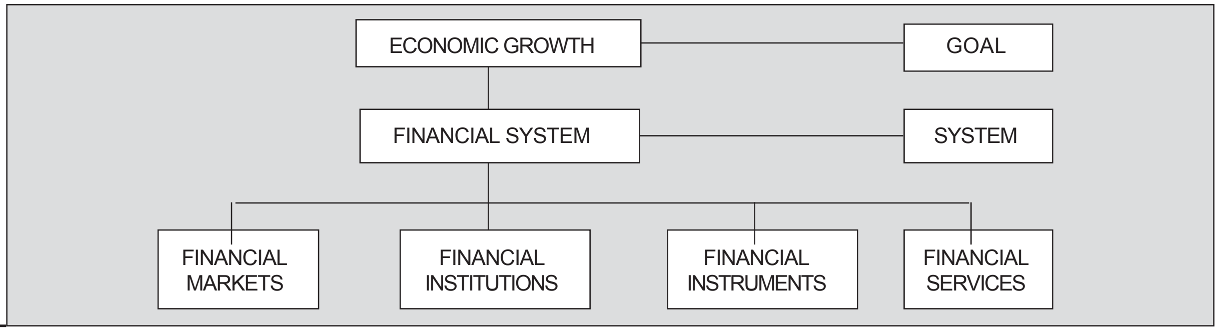


Fig. 1.2 Inter-relationship in the Financial System.

A financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the financial system. The financial system has been identified as the most catalysing agent for growth of the economy, making it one of the key inputs of development.

The Indian financial system has established a strong link between savings and investments by creating a unique mechanism through which varied economic activities are created, sustained and developed. In this background, the Indian financial system becomes the rock foundation of our economy. The financial system and the economy are complementary and have made enormous progress. It is against this backdrop that the scenario for the Indian financial system unfolds itself. The study, therefore, assumes special prominence in this context.

IN PERSPECTIVE

The process of socio-economic change is an intrinsic part of human civilization. Man has been striving endlessly to discover the secrets of nature and thereby benefit immensely in creating a peaceful, rich life for himself and his fellow-beings. Man has benefited by agricultural, industrial and information activities. According to J. K. Galbraith, there are three types of economic development that are currently in vogue. These are symbolic modernisation, maximised economic growth and selective growth. Economic growth is the *sine qua non* of change and better living standards. Over the years, a middle-of-the road social democratic thinking is becoming consolidated.

THE PRIMARY OBJECTIVE OF DEVELOPMENT

The primary objective of developing countries like India is to achieve rapid, balanced and sustained rate of economic growth. Hence, efforts are directed towards the creation of conditions in which a fast development of productive resources can take place. This inevitably necessitates the transformation of social and economic structures which will not restrain the potential productive forces and inhibit the development of resources. The state has, therefore, to devise efficient and effective strategies, at once political, economic, social, technological and cultural, so as to ensure a desirable co-ordination of all sectors of the economy and assure deliberate and requisite interest and involvement of the people. This is largely secured by adopting politically, the technique of planning and economically, the tool of management. Countries on an individual basis in the underdeveloped world are progressively and intensively resorting to centralised state management of the economy and to a restructured and neo-cultured society.

Economic development, if conceived without appropriate social changes, soon becomes stultified and stagnated. Social change cannot be achieved, if political, technological and cultural aspects are not combined and woven strategically into the fabric of economic planning. Comprehensive national planning is increasingly becoming an instrument of socio-economic transformation in developing countries. Planning delineates strategies.

LAWS OF DYNAMICS OF DEVELOPMENT

(i) 'Economic development is organically related to the impulse of change, reflecting the developmental urge of the society for self-reliance and willingness to observe rigorous discipline.'

This is a social law. This explains why there is no economic development in a particular society — regional, national or continental. The impulse to change must lead to action aimed at becoming self-reliant as quickly as possible. Self-reliance demands observance of a rigorous discipline. An urge for development, efforts towards self-reliance and a sense of discipline are the three important elements in the social law of dynamics of economic development.

(ii) 'Economic development is quickened with the degree of appropriate and intimate relationship established between and/or among competing claims, of various apparently conflicting objectives.'

This is a political law. With growing consciousness of the market economy, undeveloped and underdeveloped sectors clamour for and claim priority in development plans. Fixing of sectoral priorities and deciding the rate of progress at a given time are political decisions. The conflicting claims are to be resolved by the political leadership of the country by weaving them into supplementary and complementary relationships so as to minimise, if not entirely neutralise, their dissipating influence. The economic statesmanship of a national political leadership is displayed in harmonising the conflicting claims for economic development sector-wise, section-wise and region-wise.

(iii) 'Economic development depends upon the ability to restructure the economy with the identification of and the insistence on the economies of scale and the operational choices of technologies, resolving to the highest degree possible, the seeming or real conflict of capital versus labour.'

This is a technological law. Economy must be restructured, if it is to be balanced and self-sustained. There are economies of scale which should determine the status of economy. The relationship between large and small-scale industrial sectors should progressively settle down on this technological basis. Technologies change constantly in the modern scientific age and consequently, even the economies of scale undergo corresponding changes. This re-adjustment in the large and small-scale industries should be painlessly brought about. So also, the capital-intensive and labour-intensive operations ought to be carefully sorted out, categorised and communicated to the entrepreneurs and managers for compliance. For instance, capital-intensive techniques should give way to labour-intensive techniques in economies where labour is abundant; but this may not apply rigidly to all spheres of the economy.

(iv) 'Economic development takes place in proportion to the administrative calibre and motivation and in the direction of the comprehensive infrastructural facilities — social, educational, fiscal, financial, technical, distributional, medical, logistical and others.'

This is an administrative law. That is to say, developmental plans founded due to administrative inadequacies and procedures. Demands of development planning outstrip the administrative capabilities — not so much in terms of talent but in terms of skills. For economic development, the administration needs to know and be in tune with developmental processes, techniques and will. The administration must be fully involved and committed to development. It must be motivated so as to feel that it has the highest stake in the participation and in execution of programmes of development. Furthermore, the administration should not forget that economic development holds essence in a potential market. It tends to move in the direction of and relishes to thrive in the location, where comprehensive infrastructure exists or is shortly expected to exist. Again, economic infrastructure and fiscal/financial benefits are not enough. Man brings about development. Economic developmental facilities, without doubt, need to be provided. But many more amenities expected by the modern man are also required to be created. This naturally leads to identification of potential growth centres, which when furnished with a comprehensive infrastructure, would radiate industrial and productive activities in the ever-widening circles, round the potential epicenter.

(v) 'Economic development originates and fosters in relation to the strength and health of the local entrepreneurship and depends on the rate of its generation and equally to the intensity of its sense of social responsibility, its innovation quotient and its index of management capabilities.'

This is an entrepreneurial law. It is the entrepreneur who powers the process of economic development. The strength of an economy is in one way the strength of the entrepreneur class in the society. Mere mercantile entrepreneurship has different attributes and thrives in an entirely different atmosphere. It has to be cultured systematically in the underdeveloped regions and sub-regions. The higher the birth rate of genuine industrial and innovative entrepreneurship, faster is the rate of economic growth. Entrepreneurship must also acquire new managemental skills. Entrepreneurial density, innovative propensity and management capability in the society in a particular period determine the character and future of economic development.

(vi) 'Economic development is decisively dependent on the state of the balance of trade.'

This is a commercial law. Adverse balance of trade position restricts the development process, particularly in underdeveloped countries importing machinery, raw materials, know-how and even experts. Favourable balance of trade provides considerable latitude in the choice of imports and in the source of imports. International trade brings economic strength and techno-economic self-reliance. Again, mere exports outgrowing imports is not necessarily a sign of commercial strength. Composition of imports and exports is of great importance in this context. Commodities and unprocessed minerals may earn a fairly good amount of foreign exchange for the country; but the share of manufactured goods in the total exports of the country will indicate the degree of industrial progress and strength achieved by that country. While attempting to balance exports with imports, effort should be made to constantly expand the contribution of the manufacturing sector to national exports.

(vii) 'Economic development is directly related to the rate of national savings and of national investment in conformity with national priorities and real needs, based on social justice, economic stability and national security.'

This is a financial law. The countries and communities in which the rate of savings is high and where savings are institutionalised and thus made available for investment in productive activities according to the national priorities, are strategically advancing faster.

Economic stability leads to increased savings. Stability cannot be ensured without growth. In fact, growth and stability can be said to be synonymous terms. National investment must also ensure national security. This is possible if ample investible funds would be available at reasonable rates of interest for desirable productive purposes. It is, therefore, necessary to ensure an adequate rate of savings and institutional investments for productive activities. Mobilisation of public savings is possible when adequate incentives are provided.

The techniques of planning may have to be based on these laws of dynamics of economic development. Their ignorance or non-compliance is likely to retard and restrict the process and pace of economic development, which all the developing communities and countries cherish. Development is essentially a matter of social and economic management.

TRENDS IN ECONOMIC DEVELOPMENT

There are seven major trends affecting the direction of economic development:

- Technology as a resource
- Competition in domestic and international markets
- The role of invention
- Government as stimulator
- Entrepreneurial and Intrapreneurial development
- Innovative capital formation
- Collaborative relationships.

Technology is more than a thing, a gadget, or even a process. It is a self-generating resource that is not consumed in the process of use. Consequently, it is an important form of economic wealth.

Competition is forcing a reassessment of our individual and collective responses to the market place. Fierce domestic and international competition for scientific, technological, and economic preeminence is forcing communities and regions to leverage all their resources — human, technological and financial — to compete effectively for vibrant and diversified economies.

The countries are experiencing an unprecedented burst of invention. Myriad technological advances are occurring with incredible speed and frequency. The ability to commercialize these inventions will have direct and immediate economic consequences.

The governments are trying to find positive non-interventional approaches to encourage entrepreneurship and technological diversification. They seek to create jobs, provide benefits to the small business sector, and push technology for maximum benefits. The creation of an environment that promotes entrepreneurial activity has become a more important focal point in the government's policy on development.

People with raw energy and a proclivity for risk-taking built and sustained the countries. They are continuing to build it today — in new ways and, with new approaches. These entrepreneurs and intrapreneurs are breaking tradition and providing a dynamic source of creative and innovative enterprises. In simple words, they are giving a boost to their local economies.

Innovative capital formation is providing the catalyst for the entrepreneurial process. Mechanisms for providing seed capital and venture capital as well as an expanding venture capital industry are helping to chalk out new ventures. If the entrepreneurial process is to succeed, it is essential to continue to support and expand the formation of capital and its strategic utilization in new business development.

Finally, creative collaborative relationships are being formed between business, government, and the academicia on a large-scale. These ties are forging new opportunities for commercialization, thus accelerating the technology transfer process.

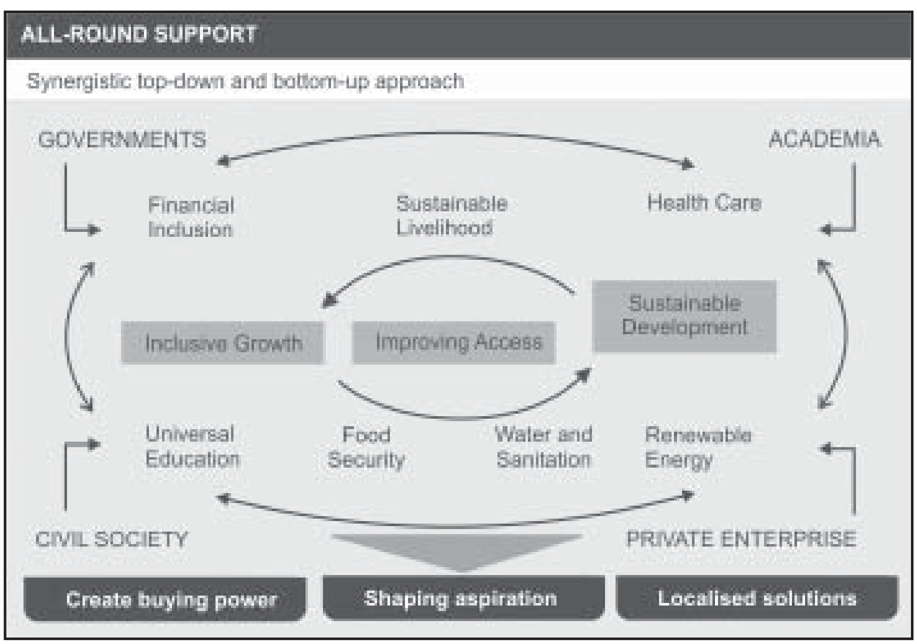
THE ROLE OF THE FINANCIAL SYSTEM

The financial sector plays a crucial role in the functioning of the economy because it allows a more efficient transfer of resources from savers to investors as well as facilitates the use of funds by households, businesses, traders and governments. In fact, an efficient financial sector spurs economic growth.

Conditions that support the development of a more robust and balanced financial structure will improve the ability of domestic financial systems to contribute to their growth. By restoring macro-economic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller disclosure of information, and levying taxes that do not fall excessively on finance, governments can lay the foundations for smoothly functioning financial systems. This study reviews the lessons of experience of the key financial sectors and tries to identify the measures that will enable domestic financial systems to provide the services needed in the next decade.

FINANCIAL INCLUSION

Financial inclusion refers to deliver of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups who tend to be excluded from the formal banking channel. Despite widespread expansion of the banking sector during the last three decades, a substantial proportion of the households especially in rural areas, is at present outside the coverage of the formal banking system. The Reserve Bank's broad approach to financial inclusion aims at 'connecting people' with the banking system and not just credit dispensation: giving people access to the payments system: and portraying financial inclusion as a viable business model and opportunity. Efforts towards ‘financial inclusion’ include sensitising the banks to the banking and financial needs of the common person and ensuring access to basic banking facilities. In consonance with the above approach, the Reserve Bank has undertaken a number of measures in recent years for attracting the financially excluded population into the formal financial system.



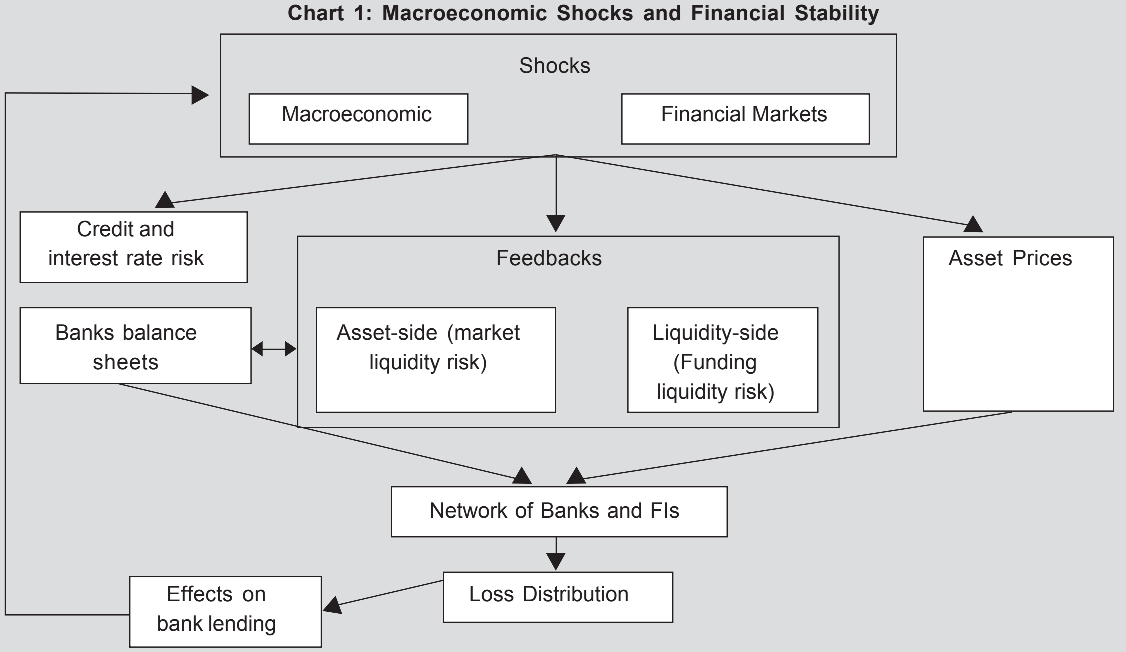
Source: YES Bank analysis and CK Prahalad & S I, Hart's *The Fortune at the Bottom of the Pyramid*

Introduction of 'zero balance' or 'no frills' accounts has enabled the common person to open bank account. However, providing banking facilities closer to the customer, especially in remote and unbanked areas, while keeping transaction costs low, remains a challenge. This has to be done with affordable infrastructure and low operational costs with the use of appropriate technology. Pursuant to the announcement banks were urged to scale up their financial inclusion efforts by utilising appropriate technology, while ensuring that the solutions developed are: (i) highly secure; (ii) amenable to audit; and (iii) follow widely accepted open standards to allow interoperability among the different systems adopted by different banks. Banks have initiated pilot projects utilising smart cards/mobile technology to increase their outreach. Biometric methods for uniquely identifying customers are also being increasingly adopted.

The linkages between macroeconomic performance and financial stability are schematically presented in Chart 1. These shocks can emanate from the real or the financial sector. Such shocks affect the banks' balance sheets through the conventional channels of credit and market risk. They also affect balance sheets through the financial markets and asset prices. Both effects may amplify the first round balance sheet impact, in particular the liquidity and network effects. Taken together, all of these channels then translate into a final impact on balance sheets, as reflected in aggregate loss distribution. A stable and resilient financial system is therefore vital for achieving sustained growth with low inflation as it can withstand fluctuations resulting from dynamic changes in economic conditions, as well as sudden and substantial increases in uncertainty.

The resilience of the financial system can be tested by subjecting the system to stress scenarios. Since the early 1990s, stress tests at the level of individual institutions have been widely applied by internationally active banks. In addition to applying such stress tests to the portfolios of individual institutions at the microlevel, stress-testing is assuming an increasingly important role in the macro-prudential analysis as well.

Chart 1: Macroeconomic Shocks and Financial Stability



Successful inclusive growth strategies, therefore, seek to rectify imbalances in a business-like manner; they are not acts of charity. What makes inclusive growth sustainable and particularly effective is that it focuses on 'capacity creation and skill development for productive employment rather than on direct income redistribution'.

While sustainable inclusive growth will be fuelled by market-driven forces of growth that enable a wider range of social sectors to access markets and equip them to be more productive, the government plays a key role in broadening access to economic opportunities and build resilience of the most-vulnerable against economic shocks.

In sum, actualising the inclusive growth vision requires coordinated efforts to synergise the initiatives of the government, private sector, community-based organisations and civil society both from top-down and bottom-up perspectives. And, private enterprise is poised to stand front and centre of India's development story, partnering key stakeholders to build collaborative frameworks for sustainable development.

Financial Innovation

Financial innovation has been both praised as the engine of growth of society and castigated for being the source of the weakness of the economy. Financial innovation is defined as the act of creating and then popularising new financial instruments, as well as new financial technologies, institutions and markets.

Economists initially tended to consider financial innovation in the same way that they consider manufacturing innovation. However, financial innovation differs from other types of new product development in several ways: predicting the social consequences of the innovation can be challenging, due to how interconnected the financial system is; the consequences of the innovation may change over time, due to the dynamic nature of the business; and new financial products and services are especially susceptible to regulation.

FINANCIAL STABILITY: CONCEPT AND MEASUREMENT

The challenge of monetary policy is to strike an optimal balance between preserving financial stability, maintaining price stability, anchoring inflation expectations, and sustaining the growth momentum. The relative emphasis between these objectives has varied from time-to-time, depending on the underlying macroeconomic conditions. The global financial crisis has underlined the importance of preserving financial stability and this has made the task for the conduct of monetary policy even more complex and challenging than before.

What is Financial Stability?

Financial stability, as a concept, is widely known. However, there is no unanimous agreement on a working definition of this concept. Some define financial stability in terms of what it is not, *i.e.,* the absence of financial instability. Others take a macro-prudential view and specify financial stability in terms of limitation of risks of significant real output losses in the presence of episodes of system-wide financial distress. Financial stability is a situation in which the financial system is capable of satisfactorily performing its three key functions simultaneously. First, the financial system is efficiently and smoothly facilitating the inter-temporal allocation of resources from savers to investors and the allocation of economic resources in general. Second, forward-looking financial risks are assessed and priced reasonably accurately and are relatively well-managed. Third, the financial system is in such a condition that it can comfortably, if not smoothly, absorb financial and real economic surprises and shocks. If any one or more of these key functions are not being satisfactorily performed. It is likely that the financial system is moving in the direction of becoming less stable, and at some point might exhibit instability. For example, inefficiencies in the allocation of capital or shortcomings in the pricing of risk can, by laying the foundations for imbalances and vulnerabilities, compromise future financial system stability.

Since financial stability poses a severe threat to important macroeconomic objectives there is a greater need for it. Financial stability as the prevalence of a financial system, which is able to ensure in a lasting way an efficient allocation of savings to investment opportunities, maintenance of a level of confidence in the financial system amongst all the participants and stakeholders and absence of excessive volatility that unduly and adversely affect real economic activity, well developed precautionary measures help in maintaining financial stability of the economy. These include development of a set of standards and codes, prudential regulation, early warning signals, supervision of financial intermediaries, compliance with international standards as regards capital adequacy norms, asset classification procedures and methods, income recognition principles, market valuations of assets and recovery mechanisms regular auditing and enforcement of rules and regulations.

The importance of financial stability emanates from four major trends in the financial systems which have become evident in recent years. There are: (i) an imbalance of growth between the financial sector and the real economy; (ii) a change in the mode of financial operations are to financial deepening (credit/debit cards); (iii) emergence of a globally integrated financial system; and (iv) an evolution of sophisticated financial instruments and attendant tasks. Consequently, the sources of crises have multiplied, necessitating the coordination of a number of authorities both within and outside country.

FINANCIAL MARKET INTEGRATION

Integration of financial markets is a process of unifying markets and enabling convergence of risk adjusted returns on the assets of similar maturity across the markets. The process of integration is facilitated by an unimpeded access of participants to various market segments. Financial markets all over the world have witnessed growing integration within as well as across boundaries spurred by deregulation, globalisation and advance in information technology integrated financial markets assume vital importance for the following reasons;

Integrated markets serve as a conduit for authorities to transmit important price signals. Efficient and integrated financial markets constitute an important vehicle for promoting domestic savings, investment and economic growth.

Fosters the necessary condition for a country's financial sector to emerge as international or as regional financial centre.

By enhancing competition and efficiency of intermediaries in their operations and allocation of resources contribute to financial stability.

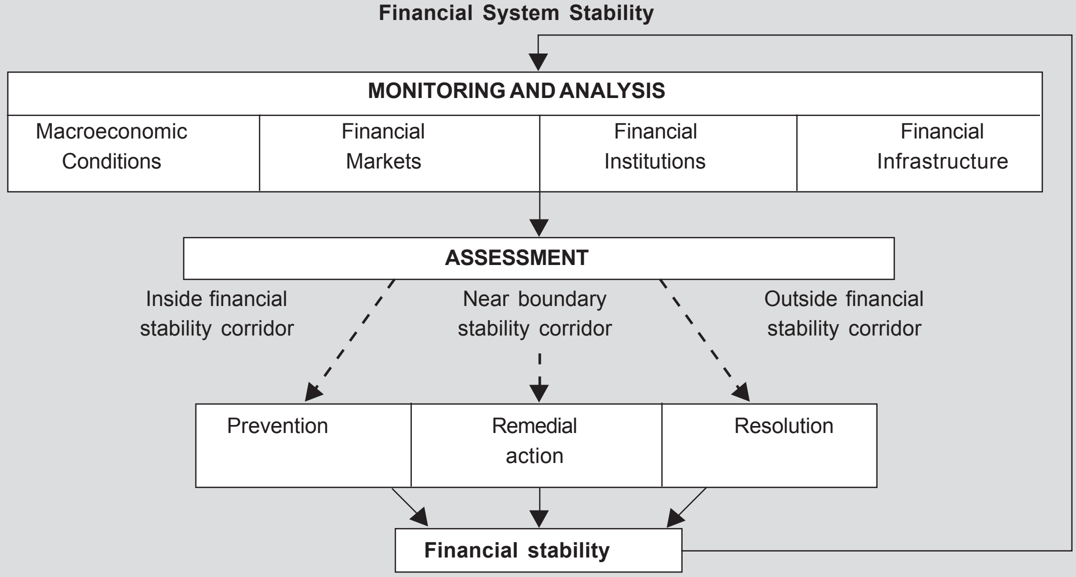
Lead to innovations and cost-effective intermediation improves access to financial services for members of the public institutions and companies.

Induce market distribution and information efficiency, and

Promotes the adoption of modern technology and payment systems to achieve cost- effective financial intermediation services.

The increased importance of financial stability is related to four major trends in the financial system. First, the financial system has expanded at a significantly faster pace than the real economy. Second, this process of financial deepening has been accompanied by a changing composition of the financial system, with an increasing share of non-monetary assets. Third, as a result of increasing cross-industry and cross-border integration, financial systems have become interwoven, both nationally and internationally. Fourth, the financial system has become much more complex in terms of the intricacies of financial instruments and diversity of activities. As a result, the sources of crises have also become manifold, necessitating the coordination of a number of authorities, both within and outside the country.

Chart: A Framework for Maintaining Financial System Stability



In the prevention mode, existing policies are maintained and updated for structural changes in order to prevent future imbalances. Surveillance of financial markets, institutions and infrastructure constitutes an important element of preventive policy. The situation changes if the financial system is close to, or at the boundary of, the range of stability.

Looking forward, the shift to a larger, more integrated, leveraged, complex and market-based financial system will continue to change the nature of financial risks. In this respect, the financial stability framework needs to be viewed as a flexible tool that can be used to interpret changes and translate these into policy implications. A major challenge, therefore, remains in developing a deeper understanding of how the different dimensions of financial stability interact with each other and with the real economy, and how these interactions are influenced by policy actions.

Table 1: Policy Instruments for Financial Stability

	Prevention	Remedial Action	Resolution
	Implementing existing policies to safeguard financial stability	Implementing pre-emptive measures to reduce emerging risks to financial stability	Reactive policy interventions aimed at restoring financial stability
Market disciplining mechanisms	Maintain, Update	Strengthen	Discretionary measures
Self-regulation	Maintain, Update	Strengthen	Discretionary measures
Financial safety nets	Maintain, Update	Strengthen	LOLR, deposit insurance
Surveillance	Maintain, Update	Intensify	Further intensify
Supervision/ regulation	Maintain, Update	Intensify	Discretionary measures
Official communication	Existing policies	Moral suasion	Restore confidence
Macroeconomic policies	Maintain, Update	Reduce imbalances	Discretionary measures
Legal system	Maintain, Update	Strengthen	Discretionary measures

LOLR – Lender of last resort

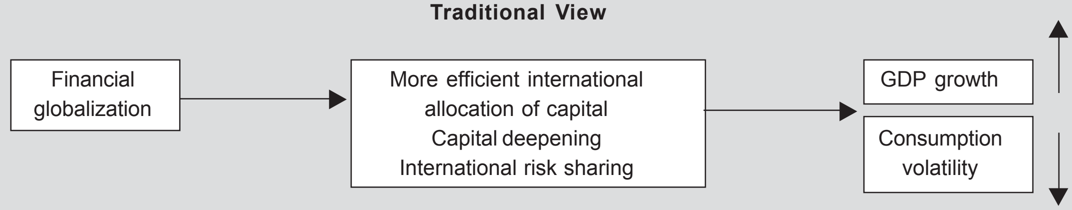
FINANCIAL GLOBALIZATION

The financial globalization is a key determinant for growth and stability. The more developed a country's financial sector the greater the growth benefits of capital inflows and the lower the country's vulnerability to crises.

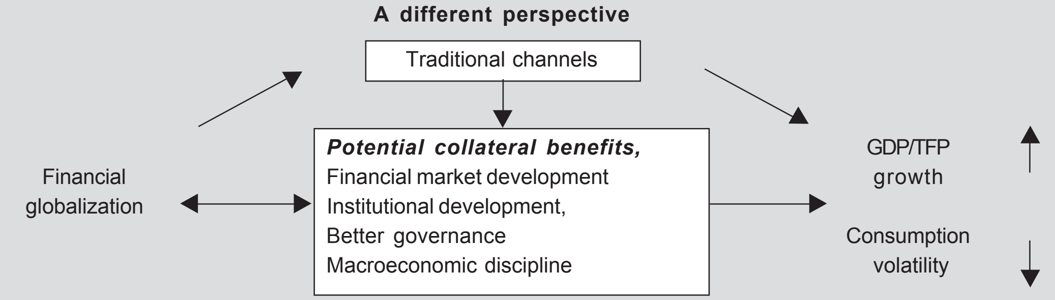
- It has a positive effect on macroeconomic stability.
- Institutional quality plays an important role in determining financial integration.
- Sound fiscal and monetary policies increase the growth benefits of capital account liberalization and help avert crises in country's open capital accounts.
- Trade integration improves the cost-benefit trade-off associated with financial integration.
- Financial globalization brings in innovative products, practices in operation.
- New technology will bring in greater growth benefits.

Financial Globalization Yields Collateral Benefits

Traditional View



The traditional view focuses on the importance of channels through which capital flows could directly increase GDP growth and reduce consumption volatility.



Our perspective acknowledges the relevance of the traditional channels but argues that the role of financial globalization as a catalyst of certain "collateral benefits" may be more important in increasing GDP/TFP growth and reducing consumption volatility.

Total factor productivity.

Fig. 1.2

Source: Finance & Development March 2007.

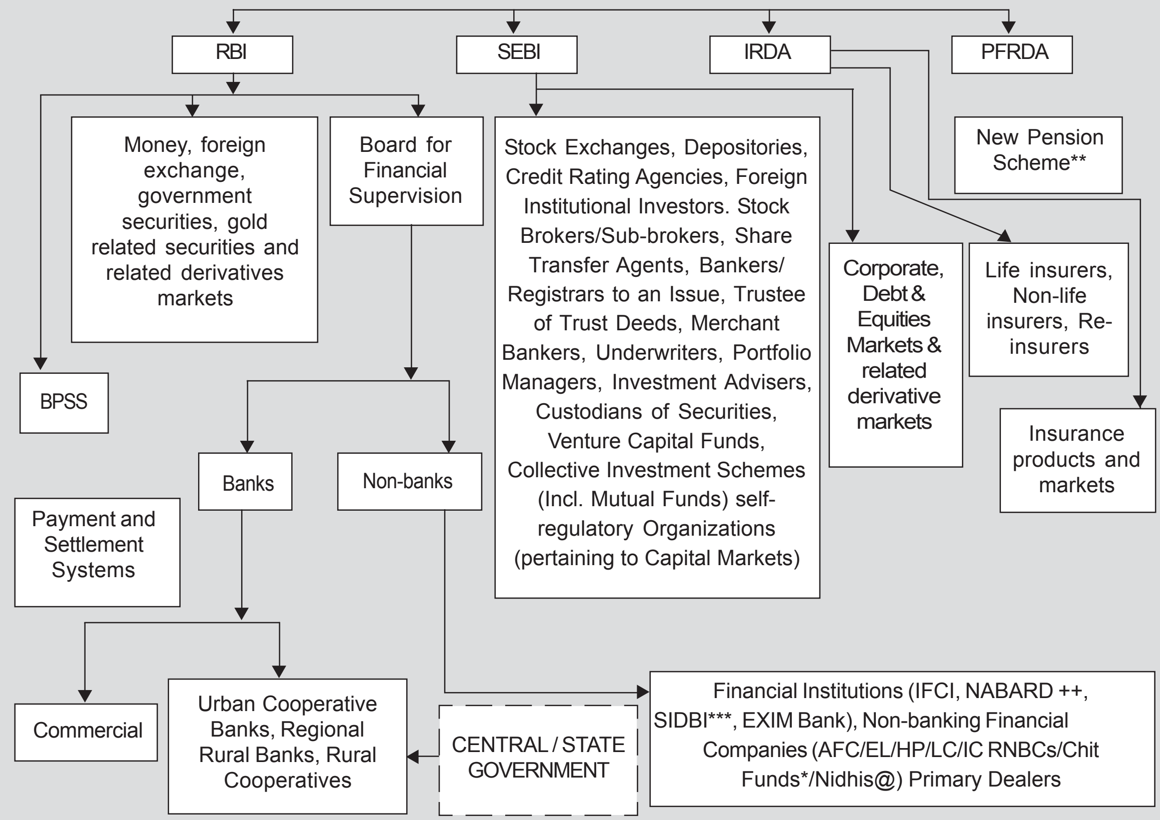
REGULATION AND SUPERVISION

Regulation and supervision of the financial system has received renewed focus in recent years in the context of the phenomenal expansion of the financial sector, technology-enabled innovations in financial products and deepening of global integration. The strategic importance of the banks in the financial system makes it imperative for the central bank— historically, the lender of the last resort and the supervisor of the banking system to pursue financial stability as an important macroeconomic objective, although, in India, there are separate institutions (viz., the SEBI the PERDA and the IRDA) to oversee the functioning of individual segments of the financial system. A number of initiatives have been taken by the Reserve Bank in reorienting the supervisory and regulatory framework and aligning it with the international best practices, while providing sufficient flexibility to the financial institutions to respond to the growing competition and the regulatory and supervisoy process in India at the current juncture is at an exciting phase and is progressing towards further, maturity aiming to impart greater strength and stability to the financial system. Therefore, the legitimate question to be posed at this juncture is 'from here to where'? It would be useful to identify the factors that may affect the functioning of the Indian banking system in the short, medium and long-term. Accordingly, the regulatory focus and the supervisory processes would need to be altered in some areas and fine-tuned in some other areas in the light of the challenges identified.

Financial systems worldwide are still evolving and the Indian financial system is not an exception. Rapid growth of computer and telecommunication technology would continue to transform the Indian financial sector. Financial innovations have been the driving force behind the blurring of distinctions among what were, traditionally, very distinct forms of financial firms. In recognition of the new market realities and progression towards universal banking, appropriate legal and regulatory changes would need to follow. The deregulation and liberalization process is like to get further expedited. Regulatory response in India has already been focused on promoting a financial system, which is based on market principles. The economic rationale for banking sector consolidation in India is unquestionable at the present juncture. The character of the ownership is undergoing change always from a predominantly government ownership. The regulatory response, against this backdrop, could play a role of facilitator while leaving the major forces to decide the extent and content of the consolidation process.

The process regulation and supervision in India has to be sharpened and diversified to ensure financial stability and maintain confidence in the financial system by enhancing the soundness and efficiency.

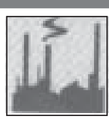
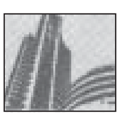
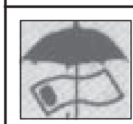
Chart 2: Regulatory Structure of the Indian Financial System – Institutions and Markets



*deposit-taking activities only: controlled by State Governments
***SIDBI regulates State Finance Corporations
@interest rate ceilings fixed by Ministry of Corporate Affairs

**PFRDA BILL 2005 is approved by the Parliament.
+ NABARD has supervisory responsibilities over rural credit institutions RRBs and cooperatives.

FINANCIAL REGULATORS

Regulator	Core Area	What's In It For You	Punitive Powers
 Competition Commission of India	To prohibit anti-competitive agreements and abuse of dominant position by enterprises.	CCI is empowered to take action against companies forming cartels to keep prices high.	Competition Appellate Tribunal, a quasi-judicial body, is empowered to impose punitive measures.
 Securities & Exchange Board of India	To protect the interests of investors in securities and to promote the develop-ment of, and to regulate the securities market.	SEBI takes steps to protect investors from frauds. It has banned many brokers from trading.	It can investigate and pass orders against persons found to be guilty of manipulating markets.
 Insurance Regulatory & Development Authority	To regulate, promote and ensure orderly growth of the insurance business and reinsurance business.	The regulator takes steps to protect the interests of the insured at the hands of insurers.	It can issue warnings and penalties on insurers and it can withdraw, suspend or cancel the registration of insurers.

Reserve Bank of India	It is the government's banker; the bankers' banker and the banking regulator. It also plays a key role in inflation management.	As the banking regulator, it's the first court of appeal for an aggrieved customer.	All banks need a licence from the RBI to carry-out their business within India, and it can be cancelled on violation of certain conditions.
 Pension Fund Regulatory & Development Authority	Regulator for the pension sector and regulates the flagship. New Pension System that offers pension solution to all individuals.	It has designed the world's cheapest pension product. Going forward, pension products will be a major savings instrument.	It can only alter any clause, it may consider necessary in the interest of the subscribers.

FSDC

The government set up Financial Stability and Development Council (FSDC), headed by the Finance Minister to oversee the Indian financial system and deal with inter-regulatory issues arising in the financial and capital markets. It had the RBI governor as chairman and the chiefs of SEBI, IRDA, and PFRDA and the finance secretary as members.

STRENGTHENING OF FINANCIAL INSTITUTIONS

The Indian financial system is a complex netwrok of institutions having a variety of functions and governed by different regulations. Besides commercial banks, which are the predominant intermediaries of the financial system, there are cooperative banks, development finance institutions, non-banking financial companies, insurance companies, provident funds and mutual funds. The Reserve Bank exercises its supervisory role over the banking system encompassing commercial and cooperative banks (UCBs) by virtue of powers provided under the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The Reserve Bank also regulates select all-India financial institutions under the Reserve Bank of India Act, 1934. Consequent upon amendments to the RBI Act in 1997, a comprehensive regulatory framework in respect of NBFCs was also introduced. In respect of state and district central cooperative banks, and regional rural banks, while the Reserve Bank is the regulator, the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD). Insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively.

(i) Broadly, the financial system comprises banking insurance, development finance, universal banking, specialised financial agencies, mutual funds, venture capital funds, stock market leasing and hire purchase, chit funds, nidhis, saving agencies, post office, factoring, housing finance, non-banking finance companies, financial consultancy, credit rate finance and other related sectors. Thus, the financial system is the backbone of the economy.

(ii) The financial system, like any other system, is to be controlled by a well defined and designed mechanism that should ensure smooth functioning, flexible operative methods and an efficient human resource pool to handle the system. The last is the most critical because the quality of the system does not ensure better results unless the human factor is capable, efficient and honest.

Finance is managing money — how to get and use it to achieve the best possible returns. It implies earning revenues by raising financial resources through various methods, planning its use, designing methods of paying back the borrowed money and interest on it, and above all, ensuring good profits on all business operations.

Technical skill is the ability to use the appropriate financial tools and techniques, procedures and systems, methods and practices. Human skill is the ability to work with other individuals and groups. You must demonstrate the ability to work, and later lead, a group of people called "a team". Conceptual skill is the mental ability to coordinate and integrate all of the organisation's interests and activities.

OUTLINE OF THE STUDY

The study consists of forty seven chapters grouped into five parts, i.e., Financial Systems, Financial Institutions, Financial Markets and Financial Instruments. In the updated edition, recent changes in the financial system have been discussed.

Part I discusses the Indian financial system's structure, evolution, macro-economic environment that has been influenced and key issues of the financial system. Even under the more optimistic environment, Indian financial systems face serious challenges. This part consists of six chapters.

Part II & III show that India has benefited from the creation of money markets and capital markets. Money markets can provide competition for banks, a flexible means for managing liquidity, a benchmark for market-based interest rates and an instrument of monetary policy. Capital market can be a source of long-term finance — both debt and equity — and can help to foster sounder corporate capital structures.

Part IV introduces the key financial institutions and examines the role of finance in development. Efficient financial institutions help to allocate resources to their best uses and are indispensable in complex, modern economies. More importantly, commercial banks are likely to remain the dominant institutions for some time. Banks and other financial institutions can be made more efficient by improving their management systems and surviving the growing global competition. This underlines the importance of adequate resolution and supervision. Because finance evolves rapidly, market regulators must continually strive for the right balance between stimulating competition and growth and limiting instability and scams and frauds. Part II comprises of twelve chapters.

Part V and VI dwell on the varied innovative financial instruments and financial services operative in the Indian financial system.

The financial system is in the process of liberalisation. A search is underway for policies as well as reforms that will strengthen the financial sector, so that it can make its full contribution to the efficient use of resources, while keeping its tendency towards instability and volatility in check. Part III and Part IV examine varied facets of the financial system in sixteen chapters.

As we enter the new millennium, we see the global economy undergoing a transition from the 'old' to the 'new' fostered by rapid advances in information technology and telecommunications, and the emergence of the Internet as a mainstream medium for conducting business. Consequently, traditional businesses are being forced to innovate and re-think the way they conduct business. With the volume of on-line business transactions increasing at an exponential rate, the momentum of this transition is only getting stronger and traditional players are being forced to realign organization structures to meet the changing needs of the new economy.

While the Internet revolution has far reaching implications for all businesses, its most dramatic impact has been on the services sector and in particular the financial services and banking industry. Internet banking or e-banking has emerged as a mainstream service delivery channel, which is providing customers unmatched convenience in terms of a location-and-time-independent service offering. E-banking presents lower transactions costs for banks, unrivalled opportunities for customization and encourages a greater degree of interactivity. At the pace and degree of technological innovation being witnessed today, customers are able to or will soon be able to carry out all their banking through electronic devices like personal computers, palmtops, laptops, mobile phones and other hand-held devices. Once this trend gains acceptance, banks with large physical branch networks will gradually lose their competitive edge.

Though the leadership status of the Indian software industry has come to be acknowledged the world over, the internet has not impacted the Indian economy to the same extent as in the West. However, this situation is expected to be remedied shortly with the growing popularity of cybercafes and the emergence of set-top boxes, both of which are expected to provide internet access at affordable rates. Further, an enabling regulator framework for e-commerce is expected shortly, with the passing of cyber-laws by Parliament. As a result, India has an opportunity to make the transition towards a knowledge-based society, which in turn promises an overall improvement in the quality of life. There is every evidence that this improvement will take place across a broad spectrum of the society including the semi-urban and rural areas. The globalisation of the economy has pushed competition in the Indian financial sector to unprecedented heights.

Conclusion

The financial system in India comprising of financial institutions, financial markets, instruments and services is characterised by two major segments – a growing organised sector and a traditional informal sector. The key to maintaining high growth with reasonable price stability lies in rapid capacity additions through investments, productivity improvements, removal of infrastructural bottlenecks ameliorating the skill shortages and improving the effectiveness of government intervention in critical areas for more inclusive growth.

The financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage saving in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables economic agents to pool, price, and exchange risk. Trade, the efficient use of resources, saving, and risk taking are the cornerstones of a growing economy.

Conditions that support the development of a more robust and balanced financial structure will improve the ability of domestic financial systems to contribute to growth. By restoring macroeconomic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller disclosure of information, and levying taxes that do not fall excessively on finance, governments can lay the foundations for smoothly functioning financial systems. The need of the hour is to develop a diversified financial system over a period of time in which both financial institutions and financial markets play important roles.

In the post-liberalisation era, the finance sector is witnessing a complete metamorphosis. Deregulation measures have included the freeing up of direct controls over ownership, liberalising interest rates and credit allocation, deregulating foreign exchange transaction controls, freeing up the entry of new firms, and expanding and broadening the base of the banking system, both for national and international business ventures. At the same time, non-banking financial institutions, securities markets and money markets have developed to mobilise and allocate savings. Experience suggests that financial liberalisation needs to be undertaken alongside macro-economic reforms.