OPEN ACCESS

Saudi Journal of Economics and Finance
Abbreviated Key Title: Saudi J Econ Fin
ISSN 2523-9414 (Print) | ISSN 2523-6563 (Online)
Scholars Middle East Publishers, Dubai, United Arab Emirates
Journal homepage: http://saudijournals.com

Review Article

The Significance of a Financial System in the Economic Advancement of a Country

Mohammad Mahmud Hasan[1*]

[1]MBA (Finance), PSM-I (USA)

DOI: https://doi.org/10.36348/sjef.2024.v08i10.001 | **Received:** 24.08.2024 | **Accepted:** 06.10.2024 | **Published:** 07.10.2024

***Corresponding author:** Mohammad Mahmud Hasan
MBA (Finance), PSM-I (USA)

Abstract

The financial system of a nation plays a crucial role in its economic development. It serves as a vital link between savings and investments, thereby fostering wealth creation. By facilitating the transfer of funds from households, which act as savers, to businesses that require investment, the system supports the growth and prosperity of both parties involved. Furthermore, the financial system is responsible for the effective allocation of savings, the provision of necessary funds, the facilitation of financial transactions, the development of financial markets, the establishment of a legal financial framework, and the delivery of financial and advisory services within the country. This system encompasses various components, including financial institutions, services, markets, and instruments, all of which are interrelated and function collaboratively. This paper addresses several issues pertinent to the Indian financial system.

Keywords: Financial System, Economic Development, Savings and Investments, Wealth Creation, Financial Institutions.

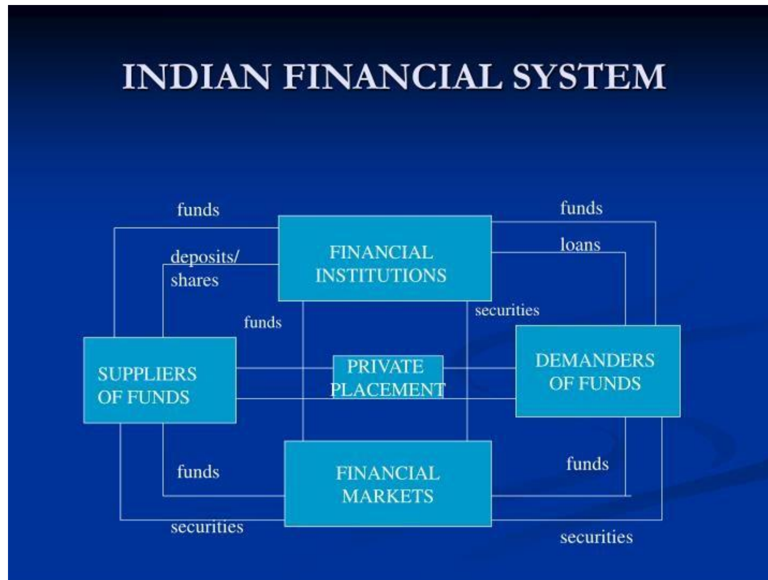
Copyright © 2024 The Author(s): This is an open-access article distributed under the terms of the Creative Commons Attribution **4.0 International License (CC BY-NC 4.0)** which permits unrestricted use, distribution, and reproduction in any medium for non-commercial use provided the original author and source are credited.

INTRODUCTION

According to Prof. Robinson, the primary function of a financial system is "to provide a link between savings and investment for creation of wealth and to permit portfolio adjustment in the composition of existing wealth". The financial system is essential for a country's economic development. It promotes savings and investment, establishes connections between savers and investors, and supports the growth of financial markets while contributing to financial deepening and broadening. By offering a range of financial instruments and effectively mobilizing savings, the financial system enhances both the rate and volume of savings. Additionally, it boosts the national output by supplying funds to corporate clients for business expansion. Furthermore, it safeguards the interests of investors and ensures seamless financial transactions through regulatory authorities such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

The financial system plays a crucial role in fostering economic development and enhancing the standard of living for individuals. It facilitates the advancement of underprivileged segments of society through the establishment of rural development banks and cooperative societies. Financial institutions assist clients in making informed financial choices by offering comprehensive financial and advisory services. This

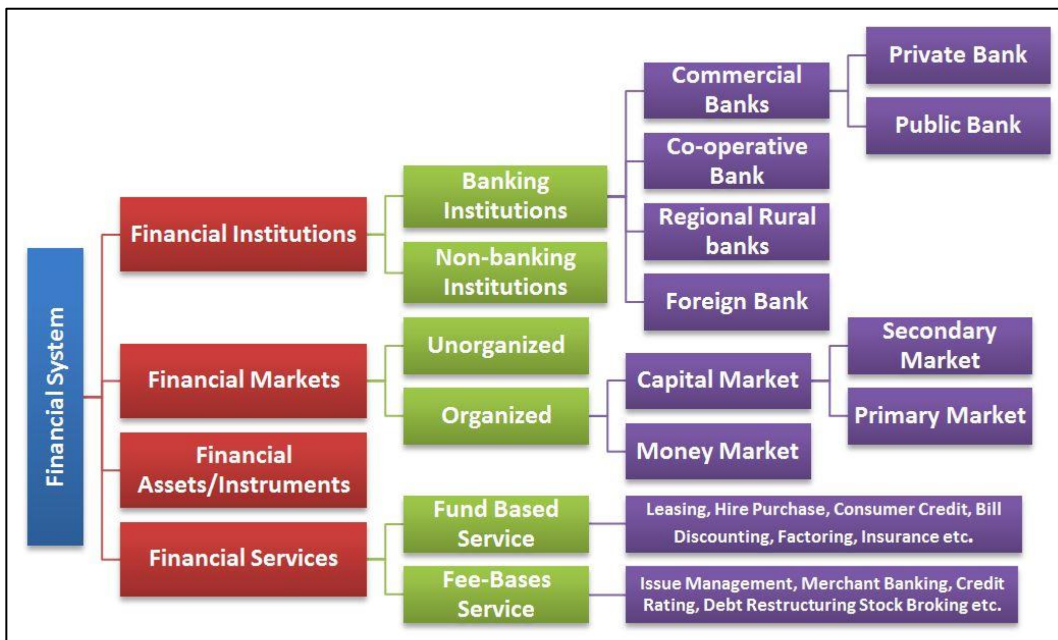
system contributes to the growth of financial assets as a proportion of GDP and encourages a greater number of participants within the financial framework.



Financial system in India

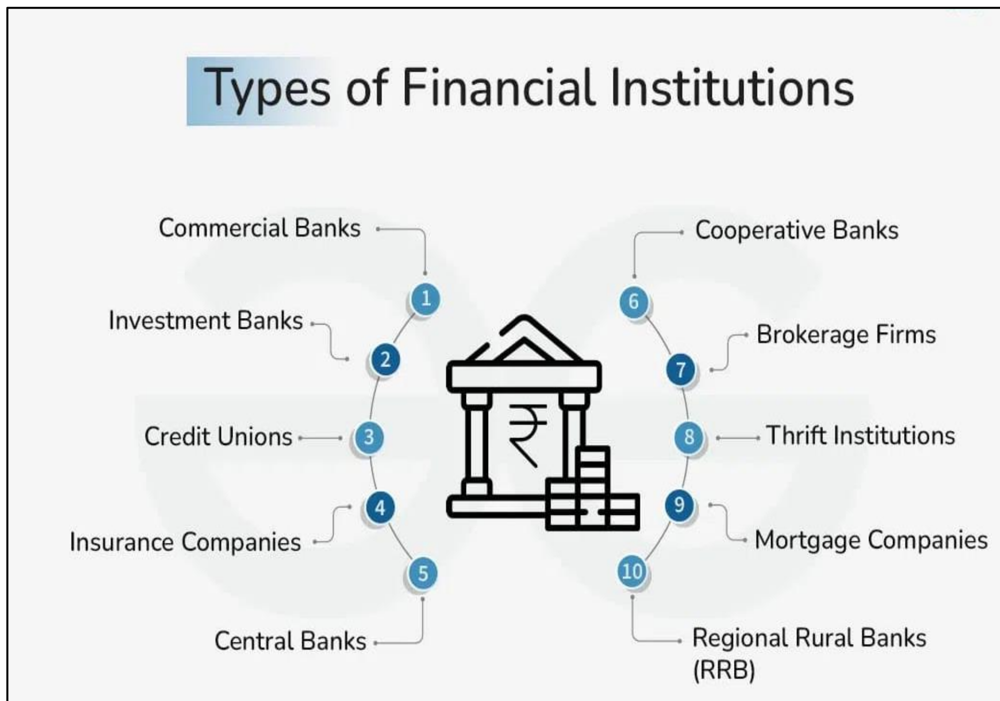
A financial system encompasses the framework for financial transactions and the movement of capital among investors, lenders, and borrowers. It can be delineated at various levels, including global, regional, or specific to individual firms. Comprising intricate and sophisticated models, financial systems illustrate the financial services, institutions, and markets that connect depositors with investors. This system is marked by the existence of integrated, organized, and regulated financial markets and institutions that address both short-term and long-term financial requirements of households and corporations alike. Financial markets and institutions are crucial components of the financial system, providing a range of financial services to the community. The Indian financial sector has undergone substantial transformation compared to its state several decades ago, particularly in the 1970s and 1980s. During the pre-reform era, the Indian financial system primarily supported the needs of planned development within a mixed-economy context, where the government played a dominant role in economic activities. Financial markets were fragmented and underdeveloped, accompanied by a limited array of financial instruments.

The current financial regulatory system



1. Financial institutions

Financial institutions serve as intermediaries within financial markets, enabling transactions between individuals and financial clients. These institutions gather funds from individuals and allocate those resources into various financial assets, including stocks, bonds, bank deposits, and loans. The subsequent list outlines the types of financial institutions.



Banking institutions: Financial institutions such as banks and credit unions gather funds from the public by offering interest on deposits, subsequently utilizing these funds to provide loans to their financial clients.

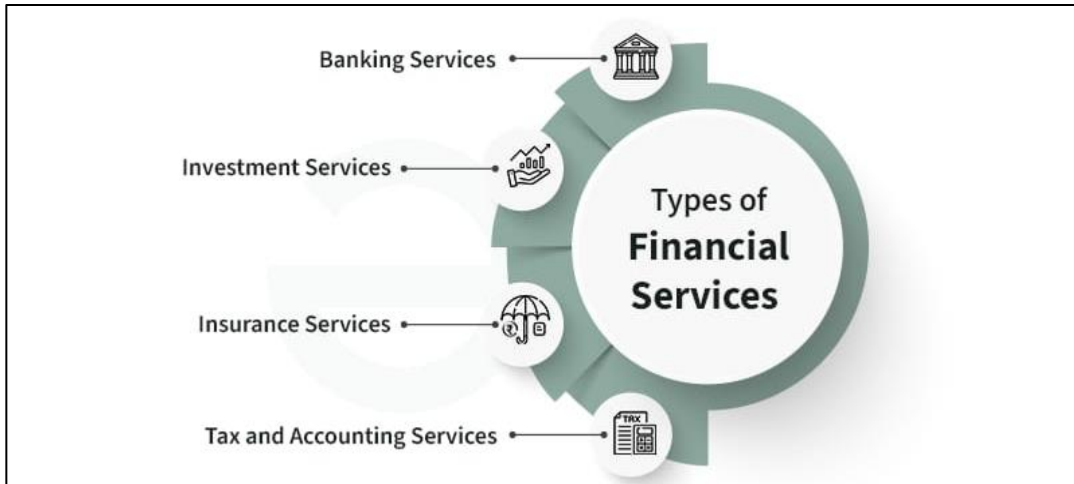
Non-banking institutions: Brokerage firms, insurance companies, and mutual fund organizations are entities that are unable to accept money deposits but are permitted to offer financial products to clients. Regulatory bodies such as the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), and Insurance Regulatory and Development Authority (IRDA) oversee the financial markets and safeguard investor interests. Intermediaries, such as commercial banks, extend short-term loans and various financial services to both individual and corporate clients. In contrast, non-intermediaries, including institutions like NABARD and IDBI, focus on providing long-term loans to corporate clients.

2. Financial markets: Financial markets serve as venues for buyers and sellers to engage in the trading of various assets, including stocks, bonds, currencies, and other financial instruments. These markets can be categorized into two main types: the capital market and the money market. The capital market focuses on long-term securities with a maturity period exceeding one year, whereas the money market is concerned with short-term debt instruments that have a maturity period of less than one year.

3. Financial assets/instruments: Financial assets encompass cash deposits, checks, loans, accounts receivable, letters of credit, bank notes, and various other financial instruments that establish a right to receive payment from an individual or financial institution. These assets may either guarantee a specific sum to be paid on a predetermined future date or ensure the repayment of the principal amount along with accrued interest.

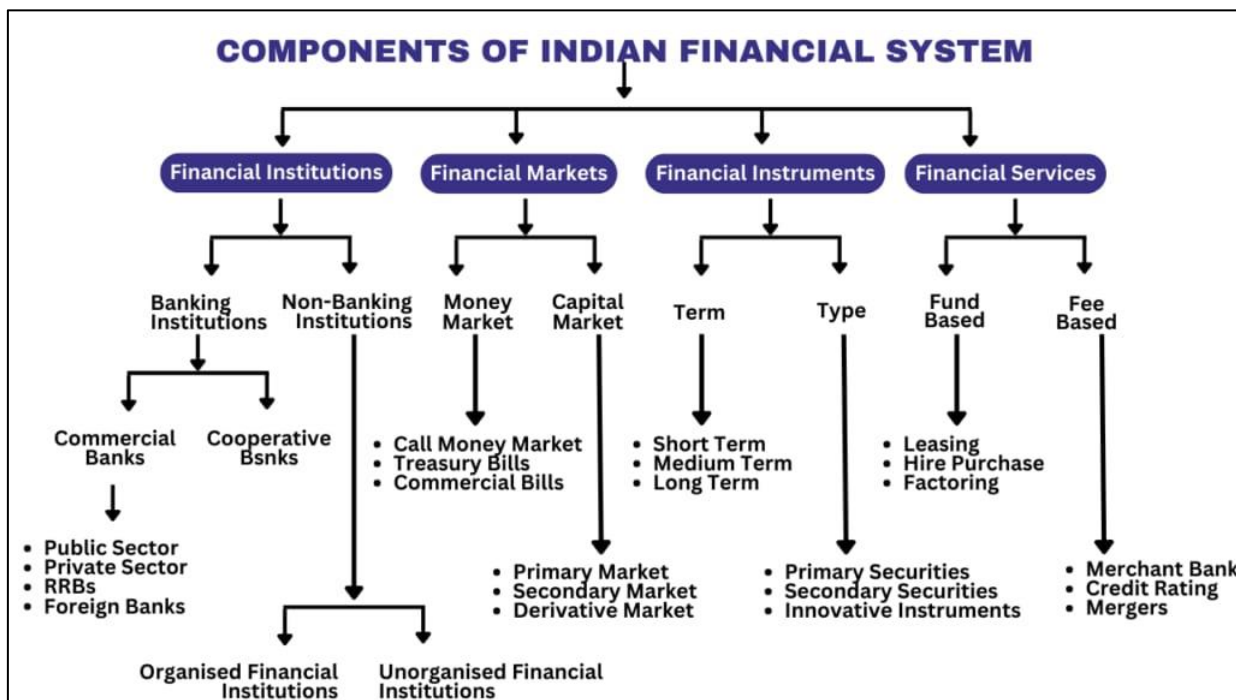
4. Financial services: The financial services sector focuses on the creation and provision of financial instruments and advisory services for both individuals and businesses. This encompasses areas such as banking and associated institutions, personal financial planning, leasing, investment management, asset management, and insurance, among others.

© 2024 | Published by Scholars Middle East Publishers, Dubai, United Arab Emirates



Components Indian financial system

The financial system serves as a conduit between savings and investment by effectively mobilizing and allocating surplus funds, thereby assisting businesses in capital formation. It plays a crucial role in risk minimization and efficient risk allocation, enabling businesses to convert tied-up funds into liquid assets. Additionally, the system facilitates financial transactions by offering a range of financial instruments and supports the trading of these assets by developing and regulating financial markets.



Review of literature

IMF (2017) [1], said that, "India's financial sector is facing considerable challenges with high non-performing assets and slow deleveraging and repair of corporate balance sheets testing the resilience of the banking system and holding back growth"

Sanjeev kumar (2017) [2], stated that, "India has a financial system that is regulated by self-governing regulators in the sectors of banking, insurance, capital markets and various sectors"

Vaishali Doshi (2016) [3], stated that, "Economic development of a nation relies on the soundness of the nation's financial system".

Objectives of the study

1. To examine the significance and function of the financial system in a nation's economic growth.
2. To analyze the shortcomings of the Indian financial system.
3. To outline the recent advancements within the Indian financial system.

Methodology of the study

The study's data and information have been sourced from secondary materials, which encompass respected journals, magazines, newspapers, reports, and online platforms.

Significance of the study

The concept of a 'financial system' encompasses the mechanisms that mobilize the savings of the public and provide essential funding to individuals and institutions in need, thereby supporting the production of goods and the provision of services. This system facilitates the exchange of funds among lenders, investors, and borrowers. It is characterized by its ability to transfer resources from those with surplus funds to those in need. The financial system consists of a complex array of interconnected services, markets, and institutions that foster an efficient and regular connection between investors and depositors. It operates at national, global, and organizational levels, incorporating public, private, and governmental sectors, along with a diverse range of financial instruments that relate to numerous assets and liabilities.

1. The association between savings and investment activities

To foster economic development, a country must enhance its investment and production capacities. This enhancement is contingent upon the existence of effective savings facilities. Such savings are funneled into productive resources through investment. The significance of financial institutions cannot be overstated, as they stimulate public savings by providing attractive interest rates. These savings are then channeled into loans for various business entities that participate in production and distribution processes.

2. Financial systems contribute to the development of the capital market

Every enterprise necessitates two categories of capital: fixed capital and working capital. Fixed capital is allocated for investments in long-term assets, such as machinery and equipment. In contrast, working capital is essential for the daily operations of the business, including the procurement of raw materials and their transformation into finished goods.

Fixed capital, is acquired via the capital market through the issuance of debentures and shares. Both the public and various financial institutions invest in these instruments to achieve favorable returns while minimizing associated risks.

Working capital, on the other hand, is obtained from the money market, where entrepreneurs can secure short-term loans by issuing different credit instruments, including bills and promissory notes.

3. Foreign exchange market:

The system facilitates exporters and importers in obtaining and providing the necessary funds for transaction settlements. Additionally, it allows banks to engage in borrowing and lending activities with diverse customers in multiple foreign currencies. This market also presents banks with opportunities to invest their short-term idle funds for profit generation. Furthermore, governments benefit from this market as it enables them to fulfill their foreign exchange needs.

4. Government Securities market:

The financial system facilitates the ability of both state and central governments to acquire funds for short-term and long-term needs through the issuance of bills and bonds that offer appealing interest rates and tax benefits. Consequently, the capital market, money market, foreign exchange market, and government securities market provide essential support to entrepreneurs, industrialists, and governmental entities in fulfilling their credit demands. This mechanism plays a crucial role in ensuring the economic development of the nation.

5. Infrastructure and growth:

The economic advancement of any nation is significantly influenced by the availability of infrastructure facilities. The lack of essential industries such as coal, power, and oil can severely impede the progress of other sectors. In this context, financial services assume a vital role by supplying the necessary funds for the development of infrastructure-related industries. The private sector often faces challenges in securing the substantial capital required to establish these industries. Historically, infrastructure projects in India were predominantly initiated by the government. However, with the advent of economic liberalization policies, an increasing number of private sector enterprises have begun to engage in infrastructure development. Development banks and merchant banks play a pivotal role in facilitating the capital needed for these initiatives.

6. Development of trade:

The financial system plays a crucial role in facilitating both domestic and international trade. Financial institutions provide funding to traders, while the financial market assists in the discounting of financial instruments, including bills. The promotion of foreign trade is supported by commercial banks through pre-shipment and post-shipment financing. Additionally, these banks issue Letters of Credit on behalf of importers. Consequently, the existence of a robust financial system enables the country to earn valuable foreign exchange.

7. The expansion of employment is facilitated by the financial system:

The establishment of a financial system will create additional job opportunities within the nation. The

money market, as a component of this financial system, supplies working capital to entrepreneurs and manufacturers, which in turn enhances production and leads to an increase in employment opportunities. As competition intensifies across various sectors, the service industry—including sales, marketing, and advertising—also experiences growth, further contributing to job creation. Additionally, a range of financial services such as leasing, factoring, and merchant banking will facilitate the generation of more employment. The expansion of trade within the country also fosters job opportunities. Furthermore, financing through venture capital offers further prospects for technology-driven industries and employment.

8. Venture capital:

The limited growth of venture capital firms in India can be attributed to several factors. A country's economic advancement is significantly accelerated when a greater number of ventures that necessitate modern technology and venture capital are encouraged. Individual companies are often unable to provide venture capital due to the inherent risks involved. Instead, it is through the financial system that various financial institutions can allocate a portion of their investable funds to support the establishment of new ventures. Consequently, the financial system plays a crucial role in facilitating the development of venture capital.

9. The financial system promotes equitable growth

Economic advancement necessitates simultaneous growth across all sectors. The primary, secondary, and tertiary sectors each require sufficient funding to thrive. Authorities must organize the financial system in such a way that resources are allocated evenly among these sectors, ensuring balanced development in industries, agriculture, and services.

10. Fiscal responsibility and economic oversight

The financial system enables the government to foster a favorable business environment, preventing excessive inflation or economic downturns. Industries should receive appropriate support through this system to fulfill their credit needs, even during challenging times. The government can generate sufficient resources to honor its financial obligations, thereby ensuring uninterrupted economic progress. Additionally, it can implement regulations within the financial system to deter undesirable or speculative activities, thereby reducing the proliferation of black money.

11. The financial system's contribution to regional equity

The financial system can facilitate the development of underprivileged areas by offering various incentives. This approach promotes balanced growth across the nation, helping to alleviate political tensions and other disturbances. Furthermore, it can help curb the migration of rural populations to urban centers.

12. Attracting Foreign Investment

A robust financial system enhances the capital market's ability to draw investments from both domestic and international sources. An influx of capital facilitates increased investment, thereby accelerating a nation's economic growth.

13. Economic Integration

The financial systems of various nations can foster economic integration, leading to the establishment of shared economic policies across these countries. This includes harmonized approaches to investment, trade, commerce, commercial law, and employment regulations.

14. Political Stability

Countries with well-developed financial systems tend to experience stable political conditions. Conversely, a volatile political environment can adversely impact both the financial system and the overall economic progress of a nation.

15. Uniform Interest Rates

A well-functioning financial system can establish uniform interest rates across the country, promoting a balanced flow of funds between different regions. This ensures that capital is accessible to various industries.

16. Technological Advancement

The advancement of technology and the integration of computers into the financial system have significantly increased transaction volumes, contributing to comprehensive national development. Additionally, the support of the World Trade Organization (WTO) has further enhanced international trade and the financial systems of its member nations.

Limitations or weaknesses of the Indian financial system

Following the advent of planning, India has experienced significant industrialization, which has subsequently fostered the expansion of both the corporate and government sectors. To address the increasing demands of these sectors, a variety of innovative financial instruments have been developed. Additionally, there has been a notable rise in financial intermediaries to cater to the diverse financial needs of various customers. Consequently, the Indian financial system has become more advanced and integrated compared to its state 50 years ago. However, it still faces several weaknesses, as outlined below:

1. Lack of coordination among different financial institutions

The Indian financial landscape comprises numerous financial intermediaries, with many key institutions being government-owned. The government also exercises control over these entities, leading to coordination challenges. The presence of multiple

institutions within the Indian financial system contributes to a deficiency in the effective collaboration and functioning of these organizations.

1. Monopolistic Market Structures

In India, certain financial institutions have grown to such an extent that they have established monopolistic market structures within the financial system. For example, the life insurance sector is predominantly controlled by the Life Insurance Corporation (LIC). Similarly, the Unit Trust of India (UTI) has effectively monopolized the mutual fund industry.

2. Prevalence of Development Banks in Industrial Financing

Development banks serve as a crucial component of the Indian financial system, holding a significant position within the capital market. Currently, industrial financing in India is primarily facilitated through financial institutions established by the government at both national and regional levels. These development banks function mainly as distribution agencies, as they primarily source their funds from their sponsors. Consequently, they are unable to effectively mobilize public savings, which poses a significant obstacle to the development of a robust financial system in the country.

3. Inactive and Unstable Capital Market

A fundamental role of any capital market is to foster economic development by channeling savings into productive investments. In the context of industrial financing in India, corporate entities can secure their financial resources through development banks, thus reducing their reliance on the capital market. Furthermore, they often avoid the capital market due to its instability and inactivity. Investors also tend to favor physical assets over financial assets, highlighting a critical weakness in the capital market that undermines the overall financial system.

4. Unsound Financial Practices

The predominance of development banks has led to the emergence of unsound financial practices among corporate entities. These banks primarily extend funds in the form of term loans, resulting in a significant reliance on debt within the financial structures of corporations. This heavy reliance on debt capital has created an imbalanced and precarious capital structure for borrowing firms. To exacerbate the situation, when corporate enterprises financial institutions allow for a higher utilization of debt than is justified, particularly when confronting financial crises. This approach contradicts the conventional understanding of a robust capital structure.

A Framework for Transformation

In recent years, various expert committees have reached a consensus on a framework for transformation. The reforms suggested by these committees necessitate legislative amendments, prompting India’s Ministry of Finance to establish the Financial Sector Legislative Reforms Commission tasked with revising the existing laws. Following two years of discussions and consultations, the commission presented the proposed Indian Financial Code. This draft legislation offers a new, modern, coherent, and consistent framework grounded in the rule of law, independence, accountability, and a primary focus on consumer protection. It supersedes the majority of current Indian financial regulations. The code delineates the authorities of the agencies overseeing the financial sector, while acknowledging that for these regulators to function effectively, they must possess clear objectives and be held accountable for their attainment.

Initiatives aimed at establishing a government agency should commence with a set of hypotheses regarding the issues that the agency is intended to address. In addition to this market-failure viewpoint, it is beneficial to consider reform through the lens of public choice theory, which perceives bureaucrats and politicians as self-serving.

The Indian financial sector has experienced significant enhancements in its performance relative to other emerging market economies. Considerable cost-efficiency and profitability have been realized in the post-reform era. Other areas of the financial market, particularly the Indian stock market, are now comparable to international stock markets in terms of turnover ratios. Currently, India boasts the third-largest investor base globally. The trading and settlement systems of the Indian stock market are of world-class standards, and India enjoys some of the lowest transaction costs worldwide, facilitated by screen-based transactions and paperless trading.

Recent advancements in the Indian financial system

India's financial system is governed by independent regulators across various sectors, including banking, insurance, capital markets, and other service industries. In several areas, the government assumes the role of regulator, with the Ministry of Finance overseeing the financial sector in the country.

The five significant developments in the Indian financial system in 2016 are as follows:

1. Withdrawal of legal tender status for Rs 500 and Rs 1000 notes
2. Establishment of the monetary policy committee
3. Enactment of the goods and services tax bill
4. Introduction of the insolvency and bankruptcy code
5. Increased emphasis on the digitization of government payments

1. Withdrawal of legal tender status for Rs 500 and Rs 1000 notes

In an effort to combat corruption and black money, the Prime Minister of India announced that the Rs 500 and Rs 1000 currency notes would cease to be legal tender effective from midnight on November 8, 2016. This decision impacted 86% of the currency in circulation at that time. The announcement was accompanied by a series of conditions for exchange and withdrawal, which have been frequently updated, leading to significant disruptions in the daily lives of citizens and businesses following the ban.

2. Establishment of the monetary policy committee

On October 4, 2016, a pivotal change occurred as a committee was formed to determine policy interest rates, replacing the previous system where the RBI Governor held sole authority. The Monetary Policy Committee, tasked with setting the benchmark policy rate (repo rate) to manage inflation within a designated target range, comprises six members: three appointed by the Central Government and three from the Reserve Bank of India, with the RBI Governor holding the deciding vote in the event of a tie.

3. Enactment of the goods and services tax (GST) bill

In an effort to eliminate numerous Central and State taxes and establish a unified tax system across the nation, both Houses of Parliament approved the Goods and Services Tax (GST) Bill in August 2016, with presidential assent granted in September. The GST encompasses a wide range of Central and State taxes, including the Value Added Tax (VAT), excise duty, service tax, central sales tax, additional customs duty, and special additional duty of customs. This initiative aims to create a consistent consumption-based tax framework for nearly all goods and services throughout the country, with the government setting a target date of April 1, 2017, for its implementation. The introduction of GST is anticipated to integrate the economy and facilitate a unified national market, allowing businesses to benefit from a streamlined tax system.

4. In May 2016, the Parliament enacted the Insolvency and Bankruptcy Code, initiating a national framework for addressing insolvencies. This new legislation replaces at least 12 existing regulations, some of which have been in place for centuries, and is expected to establish a more effective bankruptcy resolution process that enhances the ease of conducting business in India. In December, the Central Government issued the final regulations concerning the insolvency resolution process under the Liquidation and Bankruptcy Code 2016, thereby enabling the establishment of the 10-member Insolvency and Bankruptcy Board of India (IBBI).

5. The year 2016 marked significant advancements in promoting digital payments within government transactions, driven by a concerted effort from various Ministries and regulatory bodies. For example, in November 2016, the Ministry of Electronics and Information Technology introduced Procedures for Acceptance of Electronic Payments and Receipts, outlining a time-sensitive approach for integrating digital payments and receipts across all Government sectors. An ambitious deadline of December 31, 2016, was set to achieve 90% digitalization of all government outflows and receipts.

CONCLUSION

Over the last decade, the Indian financial system has experienced significant structural changes. The financial sector has gained strength, efficiency, and stability due to the interplay of competition, regulatory frameworks, and the overall policy environment. Within this context, decision-makers often lean towards choices that maintain their current advantageous positions. The reforms in the capital market during the 1990s have been noteworthy; however, further enhancements are necessary to align Indian markets with leading international standards.

Therefore, it can be concluded that a financial system serves as a conduit for lenders and borrowers to engage with one another for their mutual benefit. The ultimate gains from this engagement manifest as capital accumulation and contribute to the economic development of the nation.

REFERENCES

- IMF. Financial System Stability Assessment (FSSA) of India, Press Trust of India. Washington. Last Updated at December. 2017; 22:01:53. IST.
- Sanjeev, K. T. (2016). 19th International conference on science, technology and management, 2017. 3. Vaishali Doshi. Assistant Professor, research paper on Indian financial system-opportunities and challenges, 2016.
- Thamodaran, V. (2017). The Emerging Issues to India's Financial System, archers elevators on, 2017.
- Van Home James. Financial management and policy, 12th Edition, Pearson Education India.
- Chandra, P. (2016). Financial management, Tata McGraw Hill, New Delhi, 2016.
- Ang James B. A survey of Recent Developments in Literature of Finance and Growth. *Journal of Economic Surveys, 22*(3), 536-576.