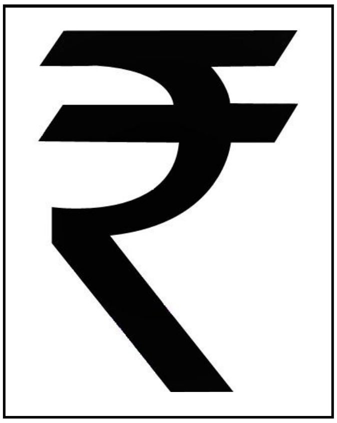
☞ Part One ☜

Financial System

CHAPTER

1 AN OVERVIEW OF THE INDIAN FINANCIAL SYSTEM

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.

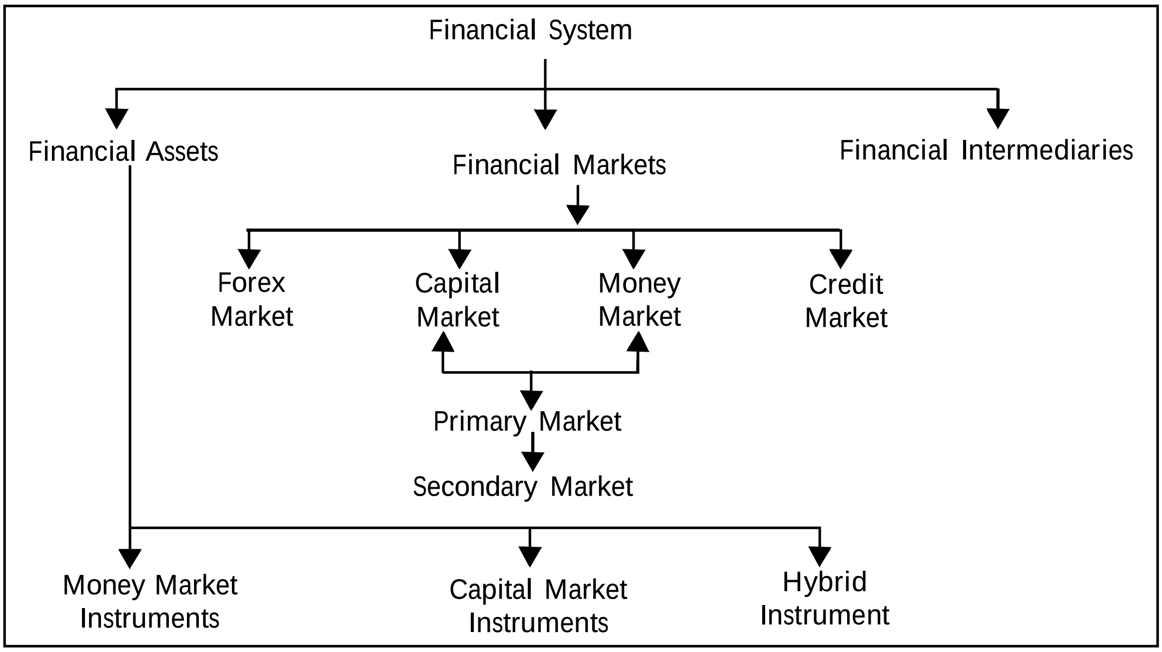


Figure 1

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 precondition 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.

WHY DOES FINANCE MATTER? **BOX: 1**

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 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.

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 or long-term, is to provide the maximum financial convenience to the public. This can be done in 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.

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.

CONSTRUCTING INDICES OF FINANCIAL DEVELOPMENT **BOX: 2**

Comprehensive index: The development of this index closely followed work done by Gelbard and Leite (1999) for sub-Saharan Africa. We began by scoring each of the dimensions of financial development. Whenever possible, quantitative data, appropriately rescaled, were used to score a country. These data included the ratio of commercial bank assets to total central bank and commercial bank assets and the ratio of broad money to GDP. In cases where qualitative data were used, a 0-1-2 scoring mechanism was adopted. All scores were rescaled so that they fell in the 0 to 2 range, with higher scores corresponding to higher levels of financial development. Next, weights were assigned to each of the 36 variables used in the construction of this index. To ensure robustness, the index was calculated using assigned weights, equal weights among the six themes, and equal weights among each of the components within the six themes. We found that the grouping of countries into high, medium, and low financial development categories was robust to the different weighting schemes, although the relative ranking of countries within each grouping changed slightly.

Alternative index: This index is related to the one developed by Beim and Calomiris (2001) and is based on quantitative data only. To construct the index, we selected four variables commonly used in the literature. The four variables were ratio of broad money to GDP; ratio of the assets of deposit-money banks to the total assets of the central bank and deposit-money banks; reserve ratio; and ratio of credit to private sector by deposit-money banks to GDP. These variables measure the size of the financial sector, the importance and relative ease with which commercial banks provide funds, and the extent to which funds are provided to the private as opposed to the public sector. We then aggregated these variables using a statistical technique called Principal Components Analysis. Aggregating not only captures different aspects of financial development in a single measure but also reduces biases or errors that may plague a particular data series. Furthermore, in keeping with the standard practice of averaging the variables in either 5-year panels or 10-year panels to smooth out business cycle fluctuations and focus on trends, we averaged the data in 10-year panels to obtain observations for the 1960s, 1970s, 1980s and 1990s.

DISTINCTIVE PHASES OF THE INDIAN FINANCIAL SYSTEM

There are four distinctive phares of the Indian financial system.

1. Before Independence

The organisation of the Indian financial system had a close resemblance of a traditional economy. L.C. Gupta describes it thus, the principal features of the pre-independence industrial financing organisation are the closed circle character of industrial entrepreneurship, a semi-organised and narrow industrial securities market devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of industry

2. After Independence

One aspect in the evolution of the Indian financial sysytem has been the progressive public ownership of financial institution.

- The fortification of the financial structure of the Indian Financial System
- A fairly well-developed capital market.
- Setting of new financial institution.
- Protection of investors
- Particiation in corproate management

3. Liberalisation of the financial system. After 1991, the Indian financial system in opened up and as well as consolidate. Regulatory and supervision strengthened.

The financial institutions focussed on growth oriented programmes. Weaker institutions were merged with stronger ones.

4. In the last phase, the indian financial system has been deepened and covered newer areas with productive instruments. Stress was laid on financial inclusion and financial stablity.

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 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. 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.

FOREIGN EQUITY INVESTMENT **BOX: 3**

Economic policies that promote sustainable growth are also likely to attract equity investment. Investor surveys show that growth and stability of the host economy are key factors in determining the attractiveness of a foreign investment. In part, this is because equity investment is relatively illiquid and sometimes requires a lengthy development phase before earning positive returns. When the foreign investment produces for the host market, as in Brazil and Korea, the investor's concern with the long-term macroeconomic environment is reinforced.

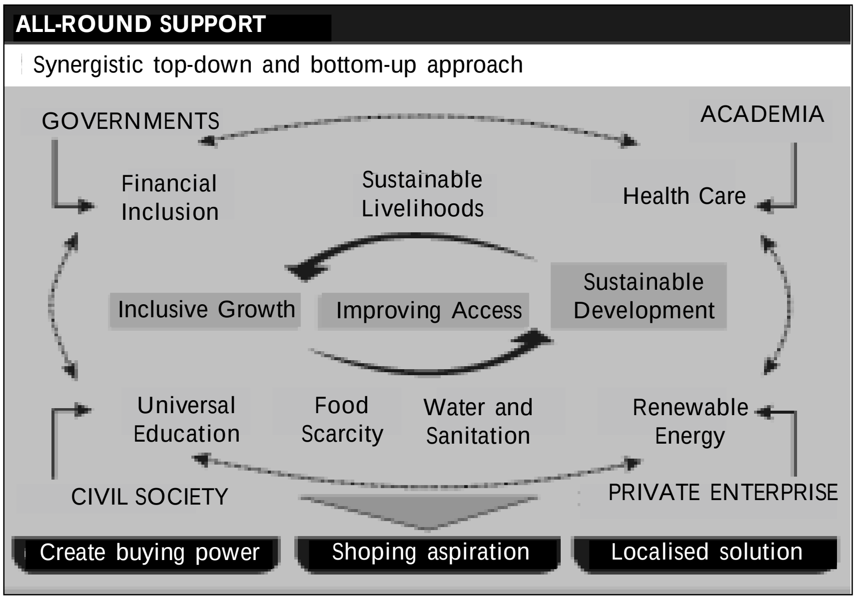
Industrial and trade policies also strongly influence foreign investment. Outward-oriented strategies supported by tax, foreign exchange, and other policies usually attract more foreign equity investment, especially to the export processing sectors. Transparent and consistent investment policies are important. Singapore, for example, treats foreign investments on essentially the same terms as domestic investments. It has attracted large flows, which, along with domestic investment, have contributed to rapid growth.

Mauritius shows that policies to provide incentives for foreign investment can work, provided the macroeconomic environment is stable. To attract foreign investment and diversify from its traditional reliance on raw sugar, it adopted an Export Processing Zone programme in 1970. Mauritius successfully expanded the share of manufactures from almost nothing to 24 per cent of total exports by 1977. But growth slowed in the late 1970s and early 1980s, partly because of failures in macroeconomic policy (currency overvaluation, fiscal overexpansion, and a tax policy that discouraged domestic saving). Foreign investment plummeted. The country adopted a structural adjustment programme in the early 1980s that called for better credit allocation, an expansion of term finance for the private sector, and investment policies aimed at further export diversification. Growth and foreign investment have revived.

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.

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.

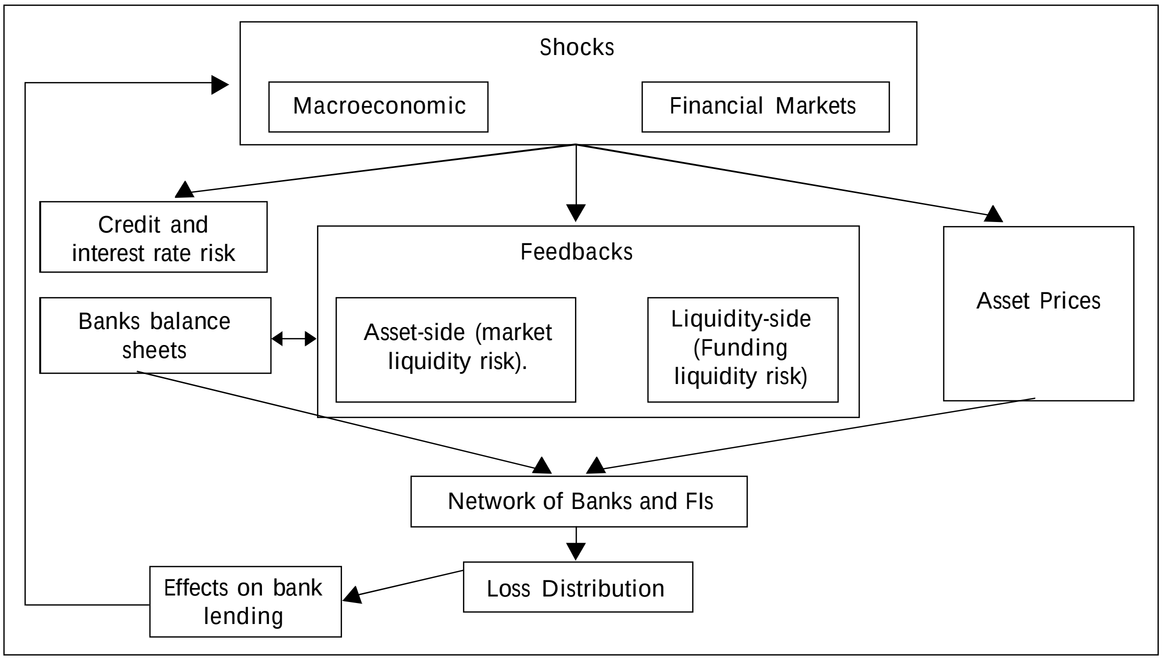


Sources: YES Rank analysis C K Prahalad & S.I. Hart's *The Fortune At The Bottom Of The Pyramid*

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 1.1: 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 co-ordinated 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 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 co-ordination 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.

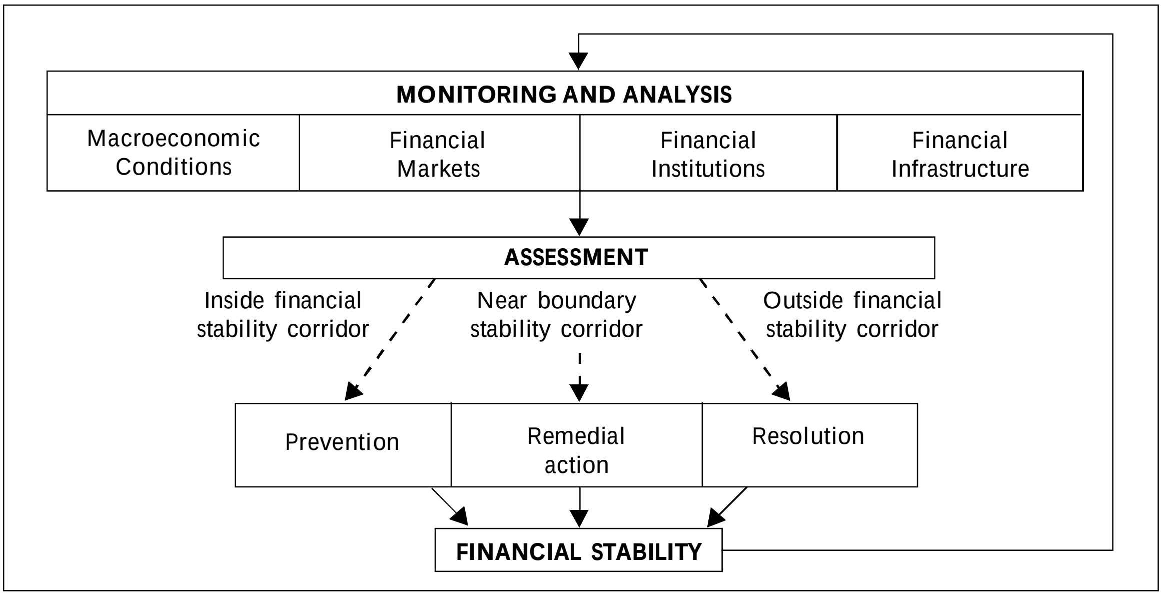
Lead to innovations and cost-effective intermediation improves access to financial services for members of the public institutions and companies.

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 1.2: 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 1.1: Policy Instruments for Financial Stability

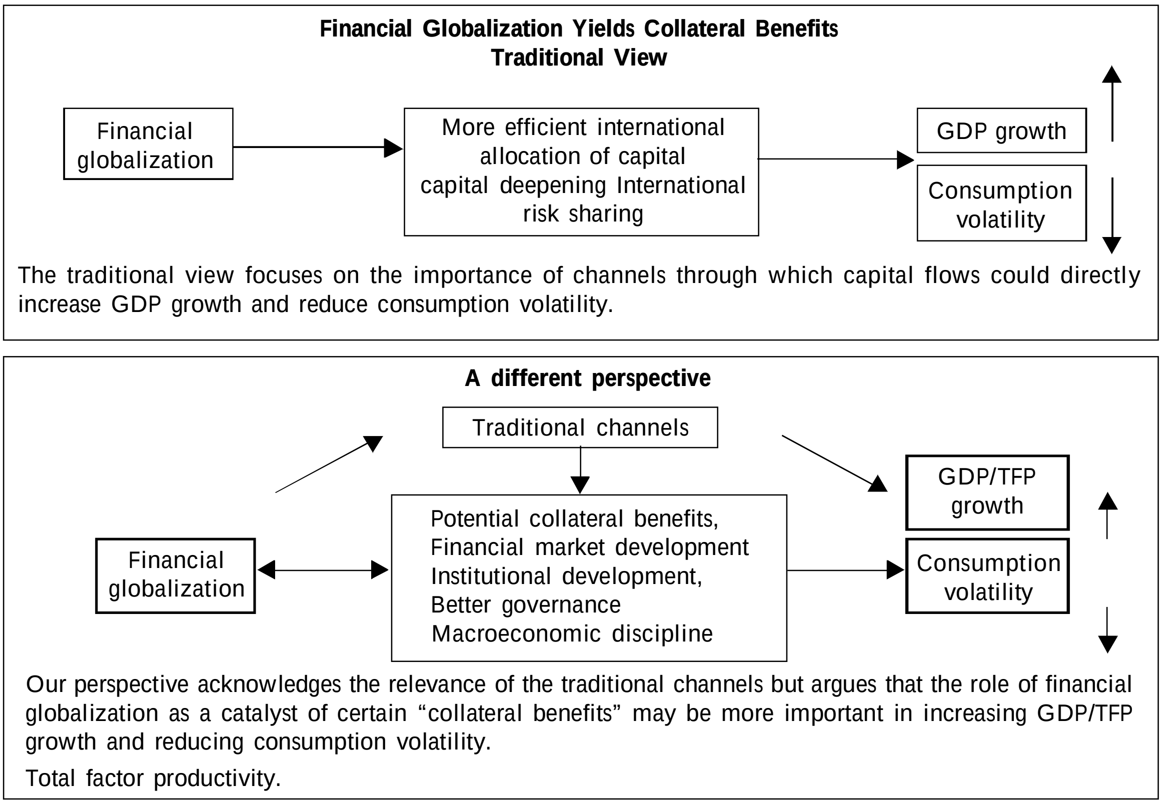
	Prevention	**Remedial Action**	**Resolution**
	Implementing existing policies to safeguard financial stability	Implementing pre-emptive measures to reduce emerging risks to financial stability	Reactive policy interventions aimed at restoring financial stability
Market disciplining mechanisms	Maintain, 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.



Source: **Finance & Development,** March 2007

Figure 2

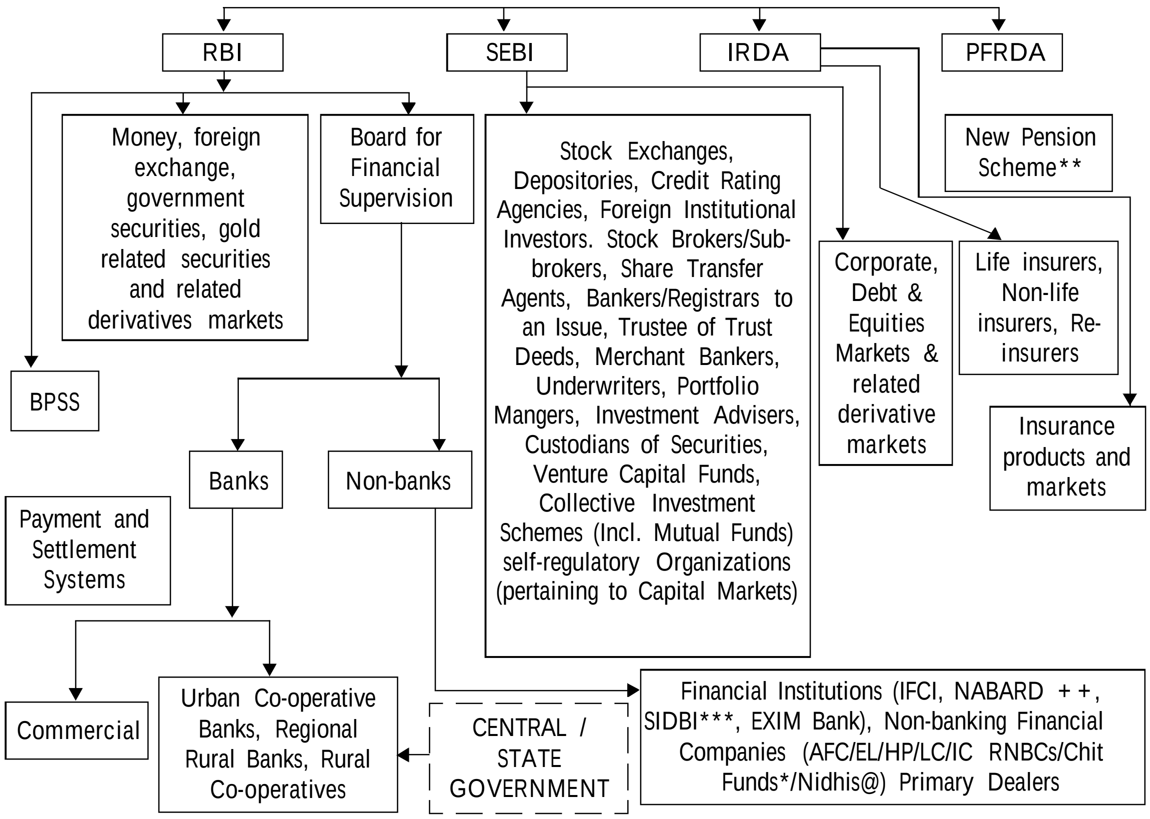
REGULATION AND SUPERVISION

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



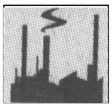
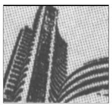
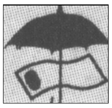
* Deposit-taking activities only: controlled by State Governments

*** 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 co-operatives.

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 development 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 network 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 co-operative 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 co-operative 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 co-operative 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, stockmarket leasing and hire purchase, chit funds, *nidhis*, saving agencies, postoffice, 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.

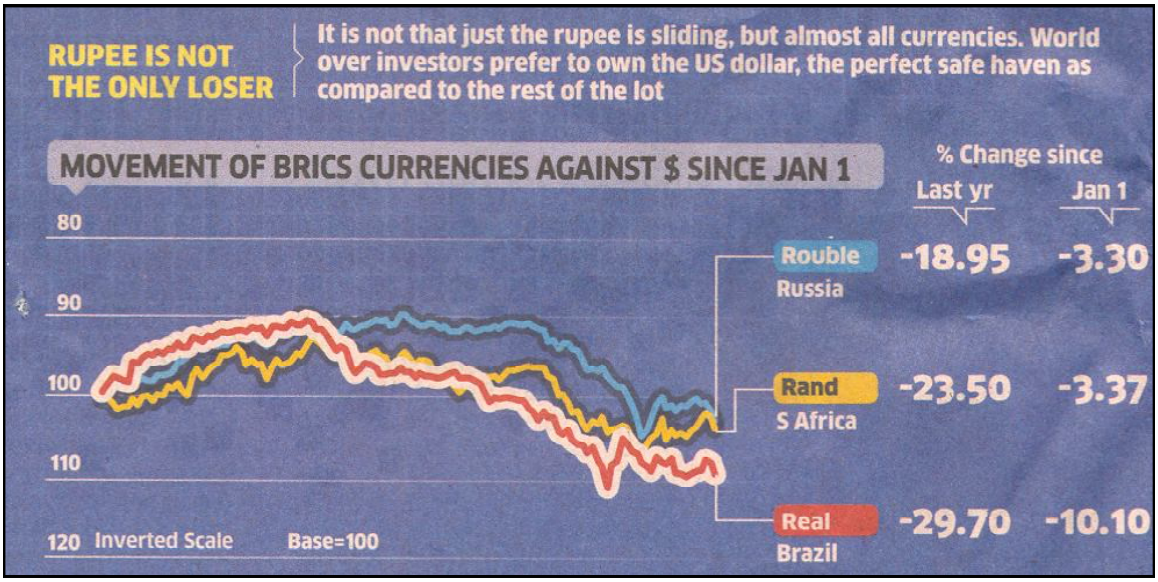
(ii) The financial system, like any other system, is to be controlled by a well defined and designed mechanism that should ensure smooth functioning, flexible operative methods and an efficient human resource pool to handle the system. The last is the most critical because the quality of the system does 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.

CONCLUSION

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, liberalizing 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 macroeconomic reforms.



SELF ASSESSMENT QUESTION

(1) Define financial system. What are the continents of financial systems

(2) Discuss the importance of financial system for an economy

(3) Write notes on:

  (a) Financial stability

  (b) Financial Inclusion

(4) Discuss the role of regulators in the financial system.