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A PERFORMANCE EVALUATION OF INDIAN FINANCIAL SYSTEM AND ITS EFFECT ON INDIAN ECONOMY

Dr. Pritish Chandra Vaish

Assistant Professor, Department of Applied Economics
Kalicharan PG College, Chowk, Lucknow

ABSTRACT

A nation's financial systems are significant to its economic growth. There is enough economic research to reveal that a healthy financial system promotes investment, growth, and economic efficiency. By utilizing a number of financial development proxy variables, this article gives a snapshot of the evolution of the Indian financial system, along with its progress and performance. The relationship between financial development and growth in the context of India is also attempted to be examined. However, the growing non-performing assets (or bad loans) of the banks and the underdeveloped corporate bond market provide a number of difficulties for the financial sector. Through its numerous components, such as financial institutions, financial markets, and financial services, the current financial system creates a link between savings and investment, channeling money from the ultimate lender to the final borrower and therefore paving the way for economic growth. The Indian Financial System and its contribution to the country's economic development are the main topics of the current analysis. The relationship between the financial system and economic growth can be understood by considering the saving and investment behaviour, how it affects GDP, the importance of capital formation for economic growth, and the credit creation hypothesis. This research additionally emphasizes the patterns of interaction between the financial system and economic development. It is an effort to comprehend how the financial system and economic growth work together in harmony.

Keywords: Financial Institutions, Economic Development, Symbiotic Relationship

INTRODUCTION

The role of financial system in promoting economic development has come under increasing scrutiny as a result of the global financial crisis. To avoid derailing the economic process, which may have a considerable impact on the structure of the financial system, policymakers across the world turned to a variety of crisis intervention strategies and regulatory reforms.

As a result, the evolving financial system may also have an impact on financial stability, volatility, and economic growth (IMF, 2012). The recent crisis also sparked worries about the point at which financial deepening has little effect on economic growth. Additionally, there has been discussion regarding the use of either a market- or bank-based financial framework to promote economic growth. In light of this, the present study investigates whether different types of financial structure contribute to India's economic progress or not. Over the 1990s, the Indian financial industry saw a prime shift. The organizational makeup, ownership distribution, and operational focus of institutions have transformed as a result of reforms, which have also increased competition in the financial industry. Due to this, financial institutions have had to change how they operate in order to expand and survive. The upheaval of technology has allowed markets to transition from antiquated systems to contemporary business practices, which has resulted in a significant decrease in transaction costs and speed of trade execution. There are, however, few studies that clearly compare India's bank-based and market-based financial systems and those that look at the relationship between finance and growth. In light of this, this paper makes the case that India's financial sector may play a crucial role in allocating resources among other sectors, either in a supply-leading or demandfollowing sequence or both, in order to optimize and broaden the country's economic development. Although both types of financial structures facilitate beneficial contributions to economic development, the bank-based financial deepening is determined to be more effective than the market-based one at promoting it. To encourage and maintain the nation's progress, an integrated financial infrastructure is required. A financial system provides the channeling of resources for productive purposes, connects institutions with surplus and deficit savings (ultimate lenders) and savings-deficit institutions (ultimate borrowers), mobilizes savings (through networks of financial intermediaries), and speeds up capital formation, which in turn affects the rate and quality of economic development. Economic development is undoubtedly the process of ensuring increased production. But in order to achieve better levels of productivity, the nation must have a high rate of physical capital production (along with human capital formation). When savings are first mobilized through (financial institutions and non-bank financial intermediaries) and then invested, the process of physical capital development is complete. A nation's financial stability, which is further influenced by how far along its financial system is in development, is one factor that affects a nation's ability to maintain economic stability. In light of this context, learning about the development and performance of the Indian financial system over time would be highly pertinent and suitable.

REVIEW OF LITERATURE

In the literature on economics, the influence of financial systems in economic development is not a new topic. Schumpeter (1911) stated more than a century ago that financial markets play a significant role in the growth process by directing capital to the most effective investors and by encouraging entrepreneurial innovation. The banker "is not so much simply a middleman in the commodity 'buying power' as a producer of this product," he said, elaborating on his point in colorful terms. He serves as a mediator between those seeking new alliances and those who control the means of production. He is primarily a development phenomenon, but only when there is no central authority controlling the social process. Two schools of thought have developed since then, each with a distinct perspective on how finance contributes to economic progress.

Robinson (1952) claimed that because of affluence, financial development lags behind economic expansion since it is a reaction to the rising demand for capital. According to Lucas (1988), finance is an "over-stressed" predictor of economic growth, which rejects the link between finance and growth. However, it is now commonly acknowledged that the financial system supports economic expansion by serving as a productive channel for dividing scarce resources among conflicting demands. This understanding of how financial intermediation affects growth has changed throughout time. Banks in particular, as well as financial intermediaries in general, were generally disregarded until the late 1960s in the process of a nation's economic progress. Influential research from the late 1960s and early 1970s emphasized the harmful effects of "financial repression" on the growth process and represented the substantial positive association between financial development and economic growth (Goldsmith, 1969; McKinnon and Shaw, 1973). The principles of endogenous growth theories were then used to argue that when capital has a positive marginal productivity, the establishment of financial markets stimulates economic growth in both the short and long terms by increasing investment efficiency.

Although the issue of causality is still up for debate, historical and econometric data point to the positive correlation between better-functioning financial markets and future economic growth, namely markets that can meet investors' and savers' needs effectively (King and Levine, 1993; Levine, et. al 1999; Levine, 2004). As a result, a more effective financial system is now seen as a vital prerequisite for greater growth. This dominant worldview encouraged some developing nations to embark on financial system reform initiatives. The balance of view has shifted even more recently, with financial intermediation now seen as contributing more towards economic growth than the conventional causes (Gorton and Winton, 2002; Boyreau Debray, 2001; Levine, 1997; and Levine, et. al 1999). Levine, 1997, 2005; Oks, 2001; Wachtel, 2001; Bagehot 1873; Zhuang, J, et al.; N. M. Odhiambo; Barajas et al.; Dabla-Norris et al.; and Aye 2015 are only a few of the authors that have extensively analyzed the relationship between financial development and economic growth in the literature. He believed that the banking industry fueled economic expansion by financing worthwhile investments. According to its definition, the latter is "a consistent state of robust functioning of multiple financial system components, including markets, institutions, and market infrastructure, endowing the system to meet any endogenousor exogenous financial shock with minimal disruptive impact" (RBI, 2015).

OBJECTIVES OF THE STUDY

1. To understand the evolution of the Indian financial system, along with its progress and performance.
2. To examine the significance of financial development and growth in the context of India.
3. To review the patterns of interaction between the financial system and economic development and assess their future implications.

METHODOLOGY

This paper is conceptual, based on secondary data with respect to all the theoretical aspects of title justification. It is mainly collected from various publications and previous thesis dissertation to support the study. The exploration has been done by considering auxiliary information from different sources, for example, books, articles, sites and online magazines of various writers and scholars along with available e-resources.

Financial System in India – A Glimpse

In India, the financial system's primary responsibility up until the early 1990s was to transfer funds from surplus to deficit sectors. The financial system did a fair job of fulfilling this role, but as time went on, some fundamental flaws started to show in how it operated. Lack of competition, a weak capital base, low productivity, and high intermediation costs all hurt the banking industry. After the nationalization of sizable banks between 1969 and 1980, the banking industry was mostly controlled by governmental ownership. Technology played a minor role, and the attention placed on service quality was insufficient. Additionally, banks failed to implement a sound risk management system, and lax prudential norms prevailed. Poor asset quality and low profitability were the end results of all these. On the other hand, Development finance institutions (DFIs) functioned in an overly protected environment among non-banking financial intermediaries, with the majority of the money coming from guaranteed sources at favorable terms. There was little competition in the insurance industry and the mutual fund sector likewise saw low levels of competition and was long dominated by the Unit Trust of India as well. The number of non-banking financial firms (NBFCs) increased quickly, although their asset side was unregulated. Financial markets were characterized by limits on the flow of money and players between market segments, control over the pricing of financial assets, entrance hurdles, high transaction costs, and barriers to entry. In addition to impeding market growth, this also reduced their effectiveness (RBI, 2003, 2004). In light of this, extensive financial sector changes were implemented in India as a crucial component of the economic reforms started in the early 1990s. Indian financial sector reforms were based on the idea that without reforming the financial sector, competitive efficiency in the actual sectors of the economy would not be attained to its full potential. Therefore, by removing structural flaws impacting the functioning of financial institutions and financial markets, the main goal of financial sector reforms was to improve the allocative efficiency of resources and speed up the growth process of the real sector. The construction of effective and stable financial institutions and markets was the main focus of changes in the financial industry.

The goal of reforms affecting both banking and nonbanking financial institutions was to create a deregulated environment that would allow the free operation of market forces while also bolstering prudential standards and the regulatory system. In order to increase efficiency, productivity, and profitability, strengthen the system, and ensure accountability and financial soundness, the banking industry laid down a strong emphasis on granting operational freedom and functional autonomy. Barriers to entry in the banking industry were gradually reduced, and restrictions on the activities carried out by the existing institutions were gradually relaxed. Reforms for non-banking financial intermediaries concentrated on addressing flaws unique to that industry. As a result, while DFI reforms concentrated on giving their operations a market orientation by eliminating guaranteed sources of funding; NBFC reforms brought its asset side under the Reserve Bank's regulation. Reforms aimed to foster a competitive environment by encouraging private sector participation in the insurance industry and mutual funds. Financial market reforms prioritized removing structural bottlenecks, adding new participants and instruments, allowing the free pricing of financial assets, relaxing quantitative constraints, and improving trading, clearing, and settlement procedures as well as increasing transparency. Regulations and laws were changed, institutional infrastructure was built, market microstructure was improved, and technology was advanced. Reforms in the different financial market segments seek to increase liquidity, depth, and a productive price discovery process too. Financial System and Economic Development A theoretical literature that is somewhat less developed investigates the dynamic linkages between finance and growth by creating models in which the financial system influences growth and the operation of the financial system is altered by growth. The relative benefits of various types of financial systems are also a topic of intense theoretical debate. Some models emphasize the benefits of a financial system based on banks, while others focus on the advantages of a financial system that relies more heavily on securities markets. The linkages between finance, overall growth, income distribution, and poverty reduction are the focus of certain new theoretical models. In each of these models, the financial industry reduces the costs associated with transactions and information. These models thereby remove the barrier that occasionally exists between the so-called real and financial sectors.

First, trading in commodities and services is made easier by the banking system. An effective financial system supports the payments mechanism and lowers the costs of information and transactions in commerce. Second, it rises saving motivation by boosting savers' self-assurance. Financial intermediaries' help investors diversify their portfolios, which maximizes profits and lowers risk for savings. Third, it is crucial in raising money and converting it into assets that can better satisfy investors' needs, whether through direct financing from the market or indirect financing from banks. Fourth, financial institutions are crucial in reducing the conflict between savers' desire for liquidity and business owners' requirement for long-term financing. Therefore, an effective financial system will enable a higher level of investment at any given level of saving by maximizing the amount of saving that actually finances investment (Pagano, 1993). Fifth, the financial system contributes significantly to the development of a pricing information process. Investors are able to allocate their funds wisely thanks to the financial system, which offers a framework for valuing businesses. Sixth, by overseeing management and exercising corporate control, the financial system can increase productivity in the business sector (Stiglitz, 1985). The effectiveness of investment projects or administration cannot be effectively verified by savers. Additionally, financial markets can boost management effectiveness by encouraging competition through successful takeover or takeover threat (Jensen and Meckling, 1976). Financial systems based on the market and bank offer unique competitive advantages on the other hand. Firm financing preferences and the effectiveness of the financial and legal institutions determine whether to use a bank-based or market-based financial system (Chakraborty and Ray, 2005). Due to their skill in identifying good and problematic borrowers, banks in particular lower the expenses associated with gathering and processing information about businesses and their managers (Boyd and Prescott, 1986; Diamond, 1984). Furthermore, Boot and Thakor (1997) contend that when investors face ex post moral hazard issues, bank lending is likely to be significant because enterprises with greater observable attributes borrow from the capital market.

CONCLUSION

The study's findings offer significant policy insights. The success of the banking industry is essential to the economy's development because the Indian financial sector is predominately focused on banks. There is still room for Indian banks to direct credit to the productive sectors of the economy given the possibility of future credit disbursement by those institutions. Therefore, one of the key lessons learned from the global financial crisis was that Indian banks needed to establish strong ties with the real economy in order to create the capacity to maintain high growth levels over a sustained period of time. The research can further be expanded by looking at the point at which financial development stops having a favorable impact on economic growth. In light of the above-mentioned IFS challenges, it is important to pay closer attention to India's financial stability at a time when the nation is likely to be exposed to the forces of globalization. New Basel-III norms will take effect in March 2019 and could have an impact on financial stability because the PSBs will need a lot of capital to comply with regulatory requirements regarding additional capital buffers. Strengthening the ecosystem for financial deepening is urgently necessary.

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