Subject	COMMERCE
Paper No and Title	Paper 16: Financial Markets and Institutions
Module No and Title	Module 3: Financial system and economic development
Module Tag	COM_P16_M3

Principal Investigator	Co- Principal Investigator		Co- Principal Investigator and Technical Coordinator
Prof K V Bhanu Murthy Professor Department of Commerce University of Delhi	**Dr. Jaswinder Singh** Principal SGTB Khalsa College University of Delhi	**Dr. R P Singh** Associate Professor SGTB Khalsa College University of Delhi	**Dr Vimal Rarh** Deputy Director, Centre for e-Learning and Assistant Professor, Department of Chemistry, SGTB Khalsa College, University of Delhi *Specialised in : e-Learning and Educational Technologies*
Paper Coordinator	**Content Writer**		**Reviewer**
Dr. Anjala Kalsie Assistant Professor Faculty of Management Studies University of Delhi	**Mr. Md. Salahuddin** Assistant Professor Kamla Nehru College University of Delhi **Ms. Tanu Dhingra** Assistant Professor Mata Sundari College University Of Delhi		**Dr. Anjala Kalsie** Assistant Professor Faculty of Management Studies University of Delhi
Anchor Institute : SGTB Khalsa College, University of Delhi			

A Gateway to All Post Graduate Courses

athshala
पाठशाला

TABLE OF CONTENTS

1. Learning Outcomes
2. Introduction
3. Meaning of the term Financial System
4. The Structure of Financial System
5. Functions of a Financial System
6. Theories explaining the interrelationship of Financial System and Economic Development
7. Financial Development
8. Role of Financial System in increasing long term prosperity—A Point of Debate
9. Summary

1. Learning Outcomes

After studying this module, you shall be able to
(a) Learn and understand the concept of financial system.
(b) Identify the nature and various components of financial system.
(c) Examine the various aspects, types and functioning of different parts of various financial system.
(d) Analyze the linkages of the different classifications of financial market and their effect on financial system.
(e) Evaluate the inter-relationship of financial system and economic development.

2. Introduction

The financial system in any economy is the most important component of growth as it facilitates mobilization of savings and its efficient allocation. This judicious allocation leads to proper utilization of scarce resources which results into the most profitable investment. Thus, the primary function of the system is to provide a link between savings and investment which leads to generation of more wealth.

3. Meaning of the term Financial System

The term financial system refers to a group of financial activities which are inter-linked with each other and in totality; these make a complete process with a specified purpose. The system has financial markets, financial institutions, financial services and financial instruments as its parts which make it a complete whole.

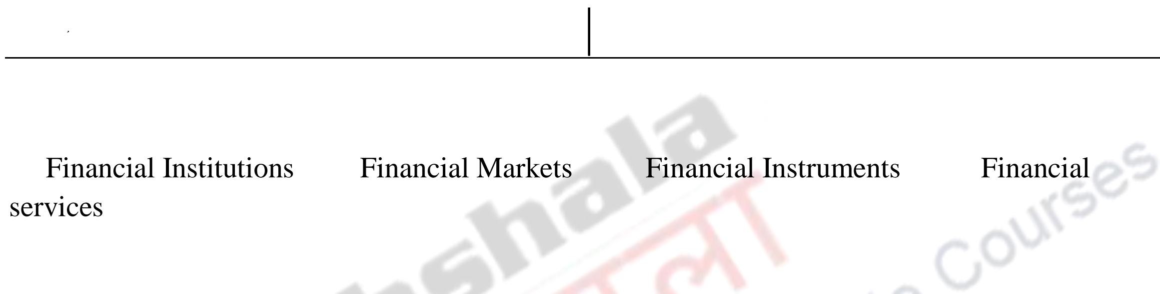
Van Horne defined financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption.

Christy has said that the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequences of price level changes or unnecessary interference with individual desires."

4. The Structure of Financial System

The financial system of any country consists of financial institutions, financial markets and financial instruments and services which facilitate transfer of funds. Financial Institutions are divided into two classifications: (1) banking and non-banking classification and (2) intermediaries and non-intermediaries. Financial markets are divided into organised and unorganised markets. Financial instruments are either short term or long term or medium term claims/assets/securities. The diagram given below explains the various components of a financial system.

FINANCIAL SYSTEM



5. Functions of a Financial System

Financial system performs the following functions

- Mobilization of resources
- Allocation of resources,
- Facilitates pooling of risk,
- Facilitates distribution, diversification and hedging of risk,
- Facilitates exchange of goods and services,
- Offers various financial instruments to suit the preference of savers and investors,
- Increases the liquidity of financial claims and,
- Facilitates better portfolio management

How efficient and effective is the transfer of funds depends upon the efficiency and soundness of the financial system of any economy. Thus, a strong and vibrant financial system contributes towards the most effective and efficient allocation of resources from surplus spending economic units to deficit spending economic units. This optimal use of resources leads to economic development.

However, there are conflicting opinions about the role of financial system in economic development. According to the Solow's model of economic growth, growth results predominantly not from the increase in labour and capital but from the technological progress.

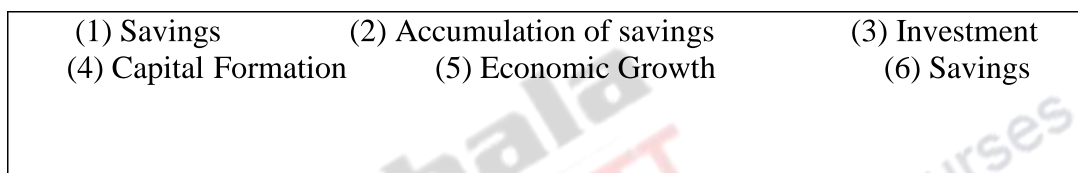
ePathshala पाठशाला A Gateway to All Post Graduate Courses

Therefore, money and finance and the policies about them cannot contribute to growth process. The other view regards money as the most important tool for economic development.

6. Theories explaining the interrelationship of Financial System and Economic Development

The inter-relation between financial system and economic development can be seen from the diagram given below:

Financial System



The interrelationship of finance, financial system and economic development can be better understood from some of the following theories.

- The classical prior savings theory
- Credit creation theory
- Forced saving theory/Inflationary financing theory
- Financial repression/Financial Regulation Theory and,
- Financial liberalization theory

5.1 The classical Prior Savings Theory

This theory is of the view that savings are a must for investment in any economy and all savings find some investment outlets. The theory stresses the need of mobilizing savings which is possible if monitory policies support high and real interest rates to be offered to public for savings which, if invested leads to economic growth.

A well-developed financial system helps in mobilizing money from surplus spending units to deficit spending units and helps in increasing the volume of investments and output, thereby transforming a given amount of investment into more productive forms. Thus, an efficient financial system increases resource allocational efficiency among different investment avenues and reduces the cost of finance and risk by providing various insurance and hedging opportunities.

5.2 Credit Creation Theory

The theory is of the view that credit is created in expectation of savings and this ensures some level of independent investment which generates the appropriate level of income which ,in turn, leads to an amount of savings equal to investment already done. Thus, investment generates income and this is facilitated by credit creation which takes place in an efficient and sound financial system. In a nutshell, the financial system facilitates generation of credit and its appropriate investment which leads to economic development.

5.3 Forced Savings Theory/Inflationary financing theory

The theory's main focus is on monetary expansion/ increase in money supply which is the catalyst of growth in an economy. As per this theory, monetary expansion leads to increase in aggregate demand, output and will induce savings. If the resources are fully employed, this monetary expansion will increase inflation which, in turn, will shift investment into physical assets rather than financial assets due to low return. This shift of portfolio will increase output and therefore savings. This is known as Tobin/Portfolio Shift Effect of monetary expansion. The theory also holds that inflation reduces the purchasing power of money which is a kind of tax on the money which redistributes money in favour of government. Thus, this theory is of the view that low interest rate is the key to economic growth as it increases investment in physical assets and thus force savings via increase in output.

5.4 Financial Repression/Regulation Theory

The proponents of this theory are of the view that allocative efficiency of the capital is improved only when interest rates are kept low by the government. Competition does not ensure efficient resource allocation, especially in the underdeveloped and imperfect markets. Financial regulation protects the less developed financial market from market failures. Competition does not ensure protection to stable payments system and it increases the possibility of bank failures and loss of public confidence. Thus, administered interest rates and finance through government intervention supports the financial market.

5.5 Financial Liberalisation Theory

The proponents of financial liberalisation are of the views that financial repression leads to fixation of low interest rates, which does not ensure allocative efficiency of capital and generally, investments take place in low productive areas with no compensating returns leading to fragile financial system. Directed credit programmes by the financial institutions does not ensure optimal utilization of scarce finance thus, adds to a burden on society with no proportionate output.

Financial liberalisation helps the financial system of an economy to strengthen. It also puts the system and the economy on the growth path. Economy starts growing at a much faster pace than ever before in terms of GDP, increase in the foreign exchange reserves, increase in the standard of living of the people and so on. Financial liberalisation offers the following advantages:

- It allows the market forces to operate freely and let the equilibrium level of interest rate to be determined through it ;

- It increases the allocative efficiency of capital into the investment projects yielding high returns;
- It increases the average productivity of capital and results in increased output;
- It increases savings and reduces the holding of real assets;
- It helps in expansion of real credit supply and;
- It leads to a sound and effective financial system thereby, increases the level of economic growth and development.

7. Financial Development

Financial development of any economy depends upon its financial structure. Financial structure of any economy, in turn, depends upon the economic progress of the country. If the economy has a strong and sound stock market, debt market, insurance companies, pension funds, mutual funds, etc.ie. an effective non banking financial sector, this shows a high level of financial development.

Financial development of any economy can be judged by the presence or absence of the following indicators.

1. Finance ratio i.e. the ratio of total issue of primary and secondary claims to national income.
2. Financial inter-relation ratio i.e. the ratio of financial assets to physical assets in the economy.
3. New issue ratio i.e. the ratio of primary issues to the physical capital formation.
4. Intermediation ratio i.e. the ratio of secondary issues to primary issues.
5. The ratio of money to national income.
6. The proportion of current account deficit financed by market flows.
7. The level of integration of domestic and international financial system.
8. The level of government intervention in credit allocation.

Thus, the indicators given above can be analyzed to judge the extent of financial development of any economy. The greater the level of financial development, the higher would be the level of economic development.

8. Role of Financial System in increasing long term prosperity—A Point of Debate

It has been said that there has been a direct link of prosperity and long term growth with the effective and efficient financial system. A strong financial system results in good economic progress, reduction in poverty, increase in the standard of living of the people. But there are many question marks to this link. The role of financial system in the economic development depends upon happenings of many a factors which, if does not happen, will not result into growth. Some of those factors are as follows:

(a) The financial system will help in the financial development if the financial system itself is efficient. Thus, the development of economy based on financial system is possible only when system works efficiently which in reality may not happen.

(b) There has been asymmetric dissemination of information which does not lead to equitable gains for all.

(c) Stock market rarely depicts fundamental valuation efficiency.

(d) Good volumes at stock market have no necessary relation with real investment.

(e) Risk reduction and better risk management is also not assured even with multiple financial instruments.

(f) Raising of funds from debt or new issue is also less and therefore, there is less funds for real new investment.

(g) Market speculation leads to high volatility in share prices.

(h) Fluctuations in trade balances also result in high volatility in foreign exchange rates.

(i) Utilization of society's resources into more productive channels is less facilitated by financial markets. It has been seen that private benefit is more than public benefit.

Thus, it may be concluded that if financial system works efficiently, only then it results into long term prosperity and growth of the economy.

e-Pathshala पाठशाला A Gateway to All Post Graduate Courses

9. Summary

The above module can be summarized as follows:

(1) The financial system represents a set of inter-related financial activities in different parts of the financial system.

(2) A sound and efficient financial system facilitates trade and therefore, specialization in mobilisation of savings and its effective distribution is assured.

(3) It has financial institutions, financial markets, financial services and financial instruments as a part of financial structure.

(4) Financial institutions reduce the cost of transferring savings to investors through risk pooling.

(5) Financial markets are the centres that provide facilities for buying and selling of financial instruments.

(6) Various theories are developed to understand the impact of financial development on economic development and role of financial system in the economic development.

(7) To understand the level/extent of financial development, various factors indicating it are discussed.

(8) Finally, whether there is a direct link between financial sector and financial development has been explored and different criterion has been used to see the link between the two.

e-Pathshala पाठशाला A Gateway to All Post Graduate Courses