International Research Journal of Management and Commerce
ISSN: (2348-9766)
Impact Factor 5.564 Volume 4, Issue 11, November 2017
Website- www.aarf.asia, **Email** : editor@aarf.asia , editoraarf@gmail.com

Role of Financial Sector in Indian Economy- An Analytical Study

Abhaykumar Gasti

Research Scholar,
Department of Commerce, Karnatak University, Dharwad

Abstract

The financial sector plays a crucial role in the economy, and evidence shows that liberalisation can improve financial sector performance, with knock-on benefits for the rest of the economy. However, there are also risks associated with liberalisation, for example in relation to financial stability, and access to financial services. Careful sequencing of reform, appropriate regulation, and other complementary policies are required to ensure liberalisation delivers the expected benefits.

Key words: Economy, Finance, Marketing, Banking and Economic System

Introduction

Financial sector is the mainstay of any economy and it contributes immensely in the mobilisation and distribution of resources. Financial sector reforms have long been viewed as significant part of the program for policy reform in developing nations. Earlier, it was thought that they were expected to increase the efficiency of resource mobilization and allocation in the real economy to generate higher rates of growth. Recently, they are also seen to be critical for macroeconomic stability. It was due to the repercussion of the East Asian crisis, since weaknesses in the financial sector are broadly regarded as one of the major causes of collapse in that region.

The elements of the financial sector are Banks, Financial Institutions, Instruments and markets which mobilise the resources from the surplus sector and channelize the same to the different needy sectors in the economy. The process of accumulative capital growth through institutionalisation of savings and investment fosters economic growth. Reform of the financial sector was recognized, from the very beginning, as an integral part of the economic reforms initiated in 1991. The economic reform process occurred amidst two serious crisis involving the financial sector the balance of payments crisis that endangered the international credibility of the country and pushed it to the edge of default; and the grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of faulty accounting strategies. Furthermore, some deep rooted problems of the Indian economy in the early nineties were also strongly related to the financial sector such as large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit. Excessive structural and micro regulation that inhibited financial innovation and increased transaction costs. Relatively inadequate level of prudential regulation in the financial sector. Poorly developed debt and money markets. And outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient (Mathieu, 1998).

Major aims of the financial sector reforms are to allocate the resources proficiently, increasing the return on investment and hastened growth of the real sectors in the economy. The processes introduced by the Government of India under the reform process are intended to upturn the operational efficiency of each of the constituent of the financial sector.

The major delineations of the financial sector reforms in India were found as under:

- Removal of the erstwhile existing financial repression.
- Creation of an efficient, productive and profitable financial sector.
- Enabling the process of price discovery by the market determination of interest rates that improves allocate efficiency of resources.

- Providing operational and functional autonomy to institutions.
- Preparing the financial system for increasing international competition.
- Opening the external sector in a calibrated manner.
- Promoting financial stability in the wake of domestic and external shocks.

At global level, financial sector reforms have been driven by two apparently contrary forces. The first is a thrust towards liberalization, which seeks to decrease, if not eliminate a number of direct controls over banks and other financial market participants. The second is a thrust in favour of strict regulation of the financial sector. This dual approach is also apparent in the reforms tried in India.

The role of the financial sector, and benefits of market opening

Evidence suggests that the financial sector plays a crucial role in the economy, underpinning private sector development, facilitating investment in businesses, technology, and training, and contributing to productivity, competitiveness and growth. Access to financial services also contributes directly to poverty reduction, enabling poor households to strengthen their livelihoods, e.g. by investing in microenterprises, and to better manage the risks they face.

Evidence also shows that opening up the financial sector to trade can significantly improve a country's overall financial sector performance, with important knock-on benefits for the rest of the economy. Openness to foreign financial services providers can result in greater efficiency, dynamism, and innovation. It can stimulate improvements in domestic banking performance, and has significant potential benefits for consumers through improved service delivery, and for the economy as a whole through a more efficient allocation of capital.

The benefits of foreign entry into the banking sector

Foreign entry is often through acquisition or joint ventures with local banks with a view to restructuring and improving their performance, and can bring significant benefits to the host country. Claessens (2006) describes how the acquisition of the government-owned Agricultural Bank of Mongolia ("Khan" Bank) by HS Securities of Japan in 2003 led to a turnaround in financial performance, expansion in its branch network and improvements in outreach and service. Foreign entry may also stimulate innovation, and the provision of new products or better services by both the foreign entrants and local banks. Bonin and Abel (2000) showed that competition from new foreign entrants in Hungary stimulated the main domestic bank to develop new products and better services for households, such as bank cards and ATMs.

Foreign banks can also use their international experience to introduce innovations. The World Development Report (2005) cites an example whereby Citibank overcame the lack of credit information on enterprises in many developing countries by introducing a new mechanism for establishing creditworthiness based on an estimate of growth prospects in particular industries. Mattoo et al (2001) found that countries that were open to trade in financial services achieved growth rates up to 1.2 percentage points higher than other countries over the period 1990–1999.

The major reforms relating to the banking system were:

- Capital base of the banks were strengthened by recapitalization, public equity issues and subordinated debt.
- Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments.
- Pre-emption of bank resources by the government was reduced sharply.
- New private sector banks were licensed and branch licensing restrictions were relaxed.

Similarly, several operational reforms were introduced in the area of credit policy:

- Detailed regulations relating to Maximum Permissible Bank Finance were abolished.
- Consortium regulations were relaxed substantially.
- Credit delivery was shifted away from cash credit to loan method.

Complementary policies required

Opening up the financial sector to trade is often just one component of a package of financial reform measures which are undertaken together, and which may include the removal of government intervention in the financial sector, privatisation, domestic market liberalisation (allowing new entry by domestic financial providers), and capital account liberalisation.

Experience from across the world shows there are significant risks associated with this wider process of financial sector liberalisation, such as the risk of financial instability, bankruptcies, and the increased chance of financial contagion when other countries experience financial difficulties. Thus a range of complementary policies, and careful sequencing of reform is now seen as important to manage these risks, and maximise the benefits of market opening. Key components include:

- a stable macroeconomic framework – to minimise the risk of financial instability;
- adequate financial supervision and regulation to encourage prudent risk taking and financial discipline in the banking system;
- the necessary institutional infrastructure, such as an effective legal framework for insolvency, and adequate corporate governance and accounting systems;
- financial deregulation, where government controls over the actions of financial institutions are removed, such as directed lending policies and interest rate ceilings, which are likely to hamper performance and deter new entry;

- bank restructuring, to resolve problems associated with high levels of non-performing loans and put domestic banks on a sustainable footing, thus avoiding bankruptcies and creating a level playing field with new foreign entrants;
- commercialisation and privatisation, to create market incentives and improve the competitiveness and productivity of domestic banks.

Implications of liberalisation for access to financial services

There has also been a concern that foreign banks will „cherry pick" the most profitable clients. Indeed, most foreign banks do focus on areas where local profit opportunities are perceived to be the greatest e.g. providing financial services to large firms in urban areas. But evidence suggests that increased competition in these market segments can still help to increase access by forcing other banks to move into new segments. At the same time, removal of directed lending, and privatisation of state-owned banks as part of an overall package of financial reform may reduce access to financial services for some segments of the population.

Governments need to create an enabling environment to reduce the costs associated with widening access by commercial banks, for example by establishing credit bureaux, creating a better legal framework to enforce contracts, and ensuring that regulation does not undermine incentives to widen access. Directive interventions which force banks to increase access are usually ineffective and counterproductive, but other, more market-friendly ways for governments to encourage access can be found. For example, the South African Financial Sector Charter, which set targets for improving access and was developed voluntarily by banks in response to moral suasion from the government, along with the introduction of a Basic Bank Account, which set the framework for banks to provide a simple, low cost, no-frills bank account for lower income customers, appear to have contributed to significant increases in access to financial services in South Africa in recent years. Harnessing the market dynamism and innovation that financial liberalisation can bring is likely to be a great deal more successful than the state-led approaches of the past in tackling the problem of financial exclusion.

Conclusion

To summarize, the financial sector is main element of the Indian economic system. Financial experts suggested that there is a need for effective reforms to ensure that this remains competitive and attractive for investors from across the world. The economic reforms have preferred the need for changing the policy objective to promotion of industries and the formation of more integrated infrastructural facilities. Financial sector reforms are centre point of the economic liberalization that was introduced in India in mid-1991. It was witnessed that national financial liberalisation has brought about the deregulation of interest rates, dismantling of directed credit, improving the banking system, enhancing the functioning of the capital market that include the government securities market. Regulators and economic experts put more emphasis on banking reforms to enhance economy and enable people to access numerous facilities. Fundamental objective of financial sector reforms in the 1990s was to create an effectual, competitive and steady that could contribute in greater measure to inspire progression.

References:

- BENNETT, ROBERT L. 1965 The Financial Sector and Economic Development—The Mexican Case. Baltimore, Md.: The Johns Hopkins Press.
- BHATIA, RATTAN J., and DEENA R. KHATKHATE 1975 “Financial Intermediation, Savings Mobilization, and Entrepreneurial Development: The African Experience.” International Monetary Fund Staff Papers 22: 132–158.
- GOLDSMITH, RAYMOND W. 1955 “Financial Structure and Economic Growth in Advanced Countries.” In A Conference of the Universities-National Bureau Committee for Economic Research, Capital Formation and Economic Growth

- GURLEY, JOHN G. and E.S. SHAW 1955 “Financial Aspects of Economic Development.” American Economic Review 45: 515–538.
- PATRICK, HUGH T. 1966 “Financial Development and Economic Growth in Underdeveloped Countries.” Economic Development and Cultural Change 14: 174–189.