AN OVERVIEW OF INDIAN FINANCIAL SYSTEM

Meaning and Definition

Financial System is a complex, well-integrated set of sub-systems of Financial institution, Markets, Instruments, and Services which facilitates the transfer and allocation of funds, efficiently and effectively.

Component of Formal Financial System

1. Regulators
2. Financial Institutions
3. Financial Markets
4. Financial Instruments/Assets
5. Financial Services

1.Regulators

The formal financial system comes under the regulations of the ministry of finance (MOF), reserve Bank of India (RBI), Securities and Exchange board of India (SEBI) and other regulatory bodies.

2. Financial Institutions

The Financial Institutions act as a *mediator* between the investor and the borrower. The investor's savings are mobilised either directly or indirectly via the Financial Markets.

The *main functions* of the Financial Institutions are as follows:

- A short term liability can be converted into a long term investment
- It helps in conversion of a risky investment into a risk-free investment
- Also acts as a medium of convenience denomination, which means, it can match a small deposit with large loans and a large deposit which small loans

- The financial institutions can further be divided into two types:

- ➢ Banking Institutions or Depository Institutions – This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need
- ➢ Non Banking Institutions or Non Depository Institutions – Insurance, mutual funds and brokerage companies fall under this category. They cannot ask for monetary deposits but sell financial products to their customers.

- Further, Financial Institutions can be classified into three categories:

- **Regulatory –** Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.
- **Intermediates –** Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.
- **Non Intermediates –** Institutions that provide financial aid to corporate customers. It includes NABARD, SIBDI, etc.

3. Financial Markets

The marketplace where buyers and sellers interact with each other and participate in trading of money, bonds, shares and other assets is called a financial market.

- The financial market can be further divided into four

i. Capital Market – Designed to finance the long term investment, the Capital market deals with transactions which are taking place in the market for over an year. The capital market can further be divided into three types:

(a) Corporate Securities Market

(b) Government Securities Market

(c) Long Term Loan Market

ii . Money Market – Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorised for small term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments. The money market can further be divided into two types:

(a) Organised Money Market

(b) Unorganised Money Market

iii. **Foreign exchange Market –** One of the most developed markets across the world, the Foreign exchange market, deals with the requirements related to multi currency. The transfer of funds in this market takes place based on the foreign currency rate.

iv. **Credit Market –** A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial & Non-Financial Institutions is called Credit Market

4. Financial Assets/Instruments

The products which are traded in the Financial Markets are called the Financial Assets. Based on the different requirements and needs of the credit seeker, the securities in the market also differ from each other.

Some important Financial Assets have been discussed briefly below:

- **Call Money** – When a loan is granted for one day and is repaid on the second day, it is called call money. No collateral securities are required for this kind of transaction.
- **Notice Money** – When a loan is granted for more than a day and for less than 14 days, it is called notice money. No collateral securities are required for this kind of transaction.

- **Term Money –** When the maturity period of a deposit is beyond 14 days, it is called term money.
- **Treasury Bills –** Also known as T-Bills, These are Government bonds or debt securities with maturity of less than a year. Buying a T-Bill menas lending money to the Government. (14/91/182/364 days i.e. less than one year).

- **Certificate of Deposits** – It is a dematerialised form (Electronically generated) for funds deposited in the bank for a specific period of time. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. CDs can be issued by(i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by RBI to raise short- term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue CDs depending on their requirements.

Commercial Paper – It is an unsecured short-term debt instrument issued by corporations. A company shall be eligible to issue CP provided - (a) the tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs. 4 crore;(b) the working capital (fund-based) limit of the company from the banking system is not less than Rs.4 crore and (c) the borrowal account of the company is classified as a Standard Asset by the financing bank/s. The minimum maturity period of CP is 7 days. The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.

5. Financial Services

- Services provided by Asset Management and Liability Management Companies. They help to get the required funds and also make sure that they are efficiently invested.
- The financial services in India include:

➢ **Banking Services** – Any small or big service provided by banks like granting loan, depositing money, issuing debit/credit cards, opening accounts, etc.

➢ **Insurance Services** – Services like issuing of insurance, selling policies, insurance undertaking and brokerages, etc. are all a part of the Insurance services

- **Investment Services** – It mostly includes asset management
- **Foreign Exchange Services** – Exchange of currency, foreign exchange, etc. are a part of the Foerign exchange services

The main aim of the financial services is to assist a person with selling, borrowing or purchasing securities, allowing payments and settlements and lending and investing.

COMMERCIAL BANKING IN INDIA

- A Bank is an institution dealing in money and credit. Credit money is the major component of money supply in a modern economy. Commercial banks are the creators of credit.
- A Commercial bank is a profit seeking business firms dealing in money or rather claims to money. It safeguards the savings of the public and give loans and advances

- The Banking Companies Act of 1949, defines banking company as —accepting for the purpose of lending or investment of deposit money from the public, repayable on demand or otherwise and withdrawable by cheque, drafts, order or otherwise‖.

FUNCTIONS OF COMMERCIAL BANK

- **I. Primary / Banking Functions :-**
- **1) Accepts Deposits :-**

  One of the main function of a bank is to accept deposits from the public. Deposits are accepted by the banks in various forms.

a) Current Account Deposits :-

b) Saving Account Deposits :-

c) Fixed Account Deposits :-

d) Recurring Account Deposits :-

2) Loans And Advances :-

Banks not only mobilize money but also lend to its credit worthy customers for maximizing profits. Loans and Advances are granted To :-

- **a) Business And Trade :-**

Commercial banks grant short-term loans to business and trade activities in following forms:-

i) Overdraft :- Commercial banks grant overdraft facility to current account holders

ii) Cash Credit :-

Cash credit is given by the bank to any businessman to meet regular working capital needs, against the security of goods or personal security. Interest is charged on actual amount drawn by the customer.

iii) Discounting Of Bills :-

When the holder of the bill is not in a position to wait till the maturity of the bill and requires cash urgently, he sells the bill of exchange to bank. Bank advance credit by discounting bills of exchange, government securities or any other approved financial instruments. The bank purchases the instruments at a discount.

iv) Money At Call :-

Banks also grant loans for a very short period, generally not exceeding 7 days. Such advances are repayable immediately at a short notice hence they are called as Money at Call or Call money. These loans are given to dealers or brokers in stock market against Collateral Securities.

v) Direct Loans :-

a) Loans are of many types like :- personal loans, term loans, call loans, participative loans, collateral loans etc.

b) Loans to Agriculture :-

c) Loans To Industries :-

d) Loans To Foreign Trade :-

e) Consumer Credit / Personal loans :-

f) Miscellaneous Advances :-

II. Secondary / Non-banking Functions :-

- **1. Agency Services:-**
- **a) Collection :-**
- **b) payment :-**
- **c) Income – Tax Consultant :-**
- **d) Sale And Purchase Of Financial Assets :-**
- **e) Trustee, Executor And Attorney :-**
- **f) E- Banking :-**

2. Utility Services :-

Modern Commercial banks also performs certain general utility services for the community, such as :-

a) Letter Of Credit :-

b) Transfer Of Funds :-

Banks arrange transfer of funds cheaply and safely from one place to another. Transfer can be in the form of Demand draft, Mail transfer Travellers cheques etc.

c) Guarantor :-

e) Locker Facility :-

f) Referee :-

g) Credit Cards :-

- **RESERVE BANK OF INDIA:**

  Reserve bank is the central bank of our country; the RBI act passed in 1934. It was set up in the year 1935. It starts it's operations from 1st April of 1935. Before that no central bank was in the country. But some of the central banking functions were performed by the imperial bank of India, which was existed in 1921 as a result of amalgamation of these presidency banks of Madras, Mumbai, and Bengal. At that time it had been performed only two functions. Those are banker to the government, and banker to banks.

- The remaining functions of central bank preformed by government of India. Therefore it was not a satisfactory arrangement hence it need a fully fledged central bank. The HILTON YOUNG COMMISSION strongly recommended for establishment of central banking in India. This commission suggested that central bank is called as reserve bank of India.

FUNCTIONS OF RESERVE BANK OF INDIA

- The followings are the functions of Reserve bank of India:
- Monopoly of note issue: The RBI has been given sole right to issue currency notes under section 22 of RBI act. There is no right to any other bank to print or issue currency notes in the country; hence it is a monopoly function which performs by RBI only.
- RBI issues its own bank notes of denomination rupees 2 and above. The other currency like one rupee note and other subsidiary coins are issued by ministry of finance under government of India.
- Banker to the Government: the RBI acts banker, agent and adviser to government as per obligation, created by section 20 of RBI act. It keeps money of central government and it collects taxes and makes payment on behave of government through its branches and the branches of State bank of India.

- Banker to the banks: Generally the commercial bank performs so many functions towards their customers. On the same way the RBI performs all this functions towards commercial banks and other banks by accepting deposits and lending loans. So it acts as a banker to all banks. All banks must need to open an account with RBI and it is mandatory to deposit a minimum of 3% on their demand and time deposits. The RBI has a right to increase the rate of minimum deposit up to 15% also.
- Lender of last resort: the RBI provides short term loans to commercial banks against eligible securities in time of need. It acts as an emergency bank to all other banks; when ever finance is needed it provides financial assistance by rediscounting the bills. Hence is known as lender of last resort.

- Credit control: One of the important functions of RBI is credit control; this power is given to it under the RBI act 1934 and the Banking Regulation act 1949. As a monetary authority of the country RBI has the responsibility to regulate the money supply and to formulate and administrate monetary policy. In a developing economy, money supply has to be expanded sufficiently to match the growth of real national income. The rate of increase in money supply has been far in excess of the rate of growth of real national income. Government budgetary deficits for financing a part of investment outlay and expansion of credit by commercial banks are the two reasons behind the expansion of money supply.

- Financing to industries: In order to assist the growth of industries the RBI played a key role in the creation of special institutions like Industrial financial corporation, Industrial development bank of India and unit trust of India. RBI provides long and medium term loans to industries for growth and development through the above institutions.
- Exchange control: RBI is the custodian of foreign exchange reserves of the country. It administrates the foreign exchange control act under the direction and control of central government. RBI issued licenses to a number of commercial banks in the country to carry out transactions involving foreign exchange. The importer and exporter are required to conduct their exchange transactions through the authorized dealers in accordance with the instructions issued by RBI. Again it also been granted the authority to fix the exchange value of rupee in terms of other currencies.

Inflation

According to public understanding, inflation is a condition which produces a rising trend in the general price level in the economy. Inflation is also a situation where there is ‘too much money chasing too few goods’.

DEFINITION OF INFLATION

Inflation can be defined as a continuous increase in the general price level of goods and services in the economy. Since inflation refers to a continuous increase in the general price level, although the price of every product and service need not increase. For example, if the inflation rate is 4%, it does not mean that all prices are increasing by 4%. It is only the average increase.

Deflation refers to a decrease in the general price level of goods and services in the economy. Deflation is the opposite of inflation.

There are various degrees of inflation, such as:

- Creeping inflation –a sustained rise in prices, i.e. by about 2%-3% per year.
- Walking Inflation --inflation is between 3-10 percent a year. It is harmful to the economy because it heats up economic growth too fast.
- Mild inflation –a sustained rise in price by about 8% to 10% per year.
- Galloping Inflation -- When inflation rises to 10 percent or more, it wreaks absolute havoc on the economy.
- Hyperinflation—occurs when monthly prices rise by 50% to 60% or more.

MEASURES OF INFLATION

The consumer price index is used to measure the rate of inflation. The consumer price index (CPI) is an index that measures changes in the average price of consumer goods and services. The CPI is also called the cost of living index.

The rate of inflation is computed as a percentage change in the CPI from one year to the next. The following formula shows how the rate of inflation is computed.

$$\text{Inflation rate} = \frac{\text{CPI this year- CPI previous year}}{\text{CPI previous year}}$$

For example, give that the CPI for the year 2000 was 121 and that for the year 2001, 110 the inflation rate using the above formula would be:

$$\text{Inflation rate} = \frac{121 - 110}{110} \times 100 = 10\%$$

CAUSES OF INFLATION

1. **Demand-pull inflation:** Demand-pull inflation is the most familiar form of inflation. Demand-pull inflation occurs when aggregate demand (AD) exceeds the aggregate supply (AS). It is caused by a rise in AD which may be due to a rise in investment by firms, of an increase in the level of government expenditure, or a rise in investment by firms, or an increase in demand for the country's exports by people in foreign countries or a combination of the four.

   The essence of demand-pull inflation is that there is 'too much money chasing too few foods'.

   Demand-pull inflation is associated with a booming economy or an economy which is near the peak of its business cycle.

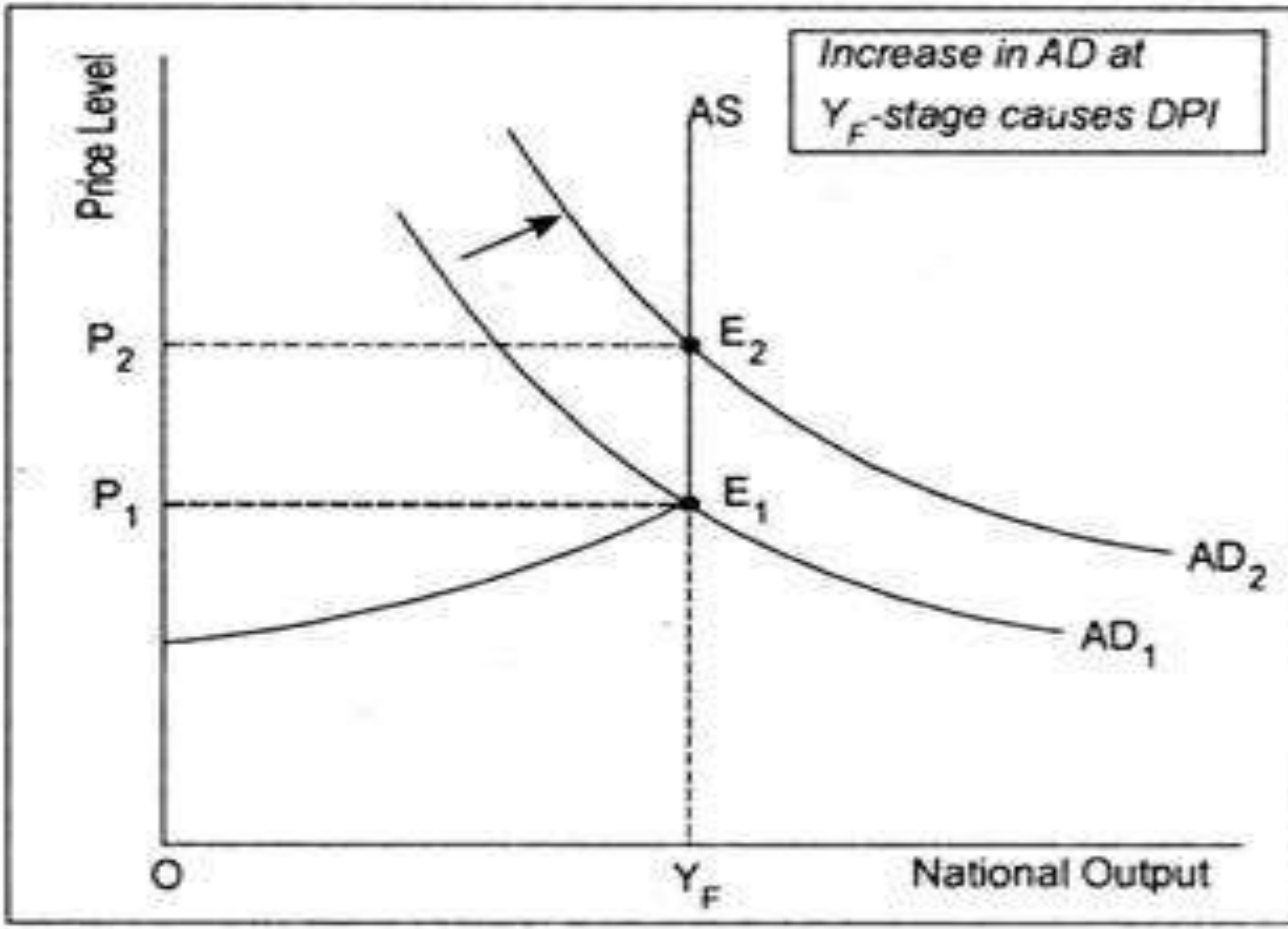

Fig. 4.3: DPI: Shifts in AD Curve

2. Cost-push Inflation

Cost-push inflation refers to an increase in the general price level associated with an increase in the cost of production. Cost-push inflation is the result of the sellers 'activities. In other words, inflation occurs due to the increase in the costs or supply prices of goods caused by an increase in the cost of inputs.

Stated in terms of aggregate demand and aggregate supply functions, the cost-push inflation arises in an economy, in the absence of excess demand, due to the pressure of various factors which shift the aggregate supply curve to the left

Cost push inflation occurs due to following reasons

- **Wage-push inflation**

  Wage-push inflation occurs due to an increase in the wage level which will lead to an increase in the cost of production and the output price. The wage level may increase due to organized labour unions seeking further wage increases through their collective bargaining strength or the firm's increasing wages to avoid the migration of workers to other firms.

- **Profit-push inflation**

  Profit-push inflation occurs when certain producers or monopolists stock up on goods and create an artificial shortage which will increase the price on these goods, thereby giving them higher profits.

- **Import-push inflation**

  Import-push inflation occurs when the prices of imported raw materials or finished goods increase. This may be the due to the fluctuation of the foreign exchange rate. This will lead to an increase in production cost and eventually an increase in the price of outputs.

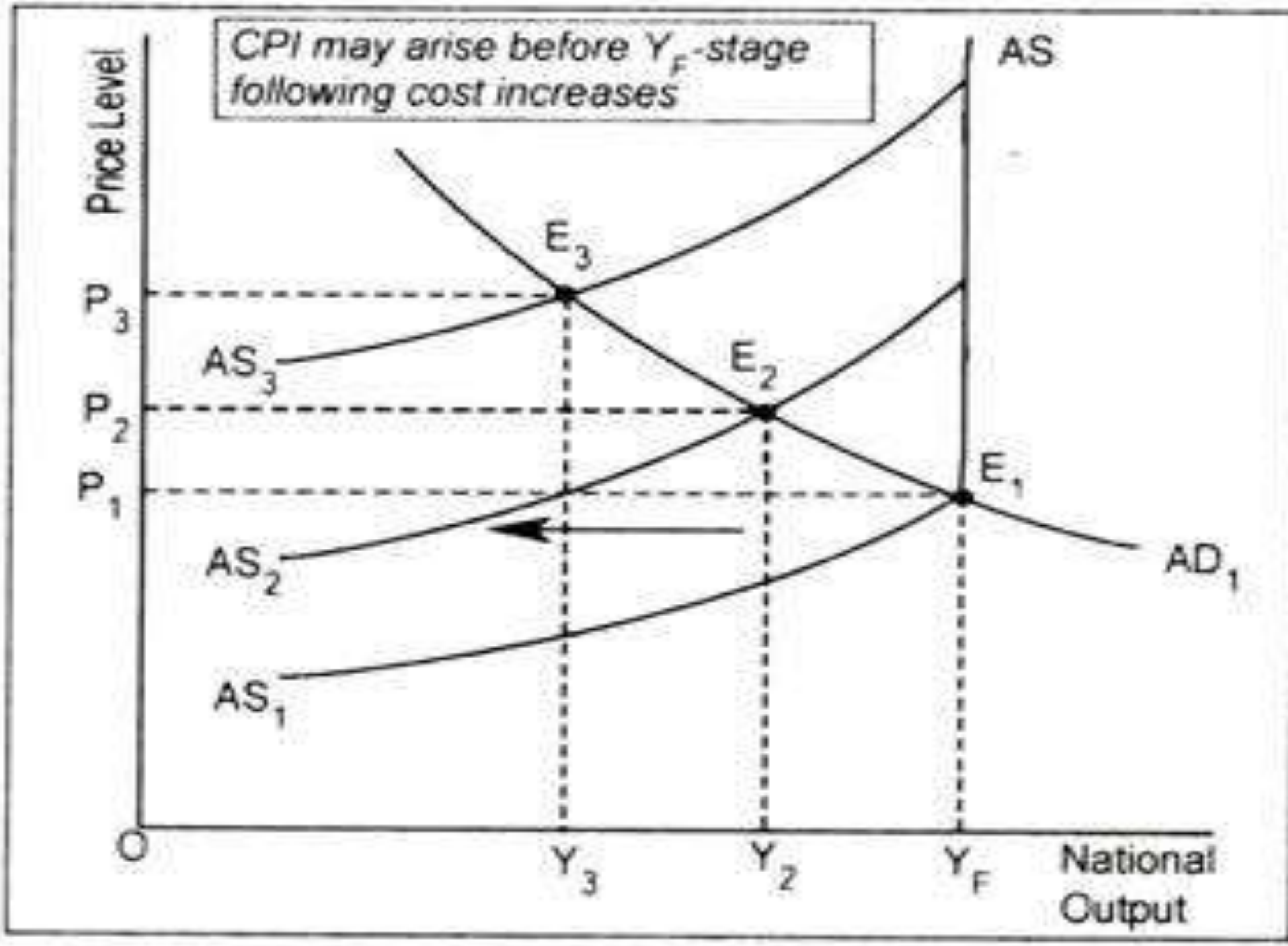

Fig. 4.4: CPI: Shifts in AS Curve

Measures to control inflation

- **The following are some important measure to control inflation:**
  - **Monetary Policy**
  - **Fiscal policy**
  - **Direct control measures**

- Monetary Policy: It consists of controlling the supply of money by the central bank of the country by using some monetary instruments which reduce the supply of money with the people.

a) Open market operations-selling of securities or short term bonds:

The sale of short term bonds or government securities and treasury bills to the people and banking companies by the central bank directly reduces the total amount of cash balances in the hands of public or cash reserves with the commercial banks

b) Raising the reserve requirement:

The central bank would raise the reserve requirement to reduce cash resources with the commercial banks and force them to restrict their lending activities, which in turn reduce the investment activities of the people and their income, thus reduces the supply of money.

c) Raising the discount rate/bank rate:

A rise in the bank rate by the Reserve bank squeezes the prevailing credit to control inflation. A rise in the discount rate or bank rate also raises the cost of borrowing funds from banks for businesses and this forces the banking system to re-examine its lending policies.

d) Raising the interest rate:

The central bank would persuade commercial banks to increase their rate of interest on deposits from public. The high rate of interest will attract and encourage more people to save their surplus with banks will divert savings to banks from corporate sector and reduce supply of money.

e)) Selective credit control policy:

The selective credit control policy takes the form of issuing directives to commercial banks to prohibiting them from lending against certain commodities or reducing the total credit limit granted to the public.

- Fiscal policy:A decrease in government spending and an increase in the government revenue will produce a surplus budget. This is an important fiscal measure which reduces the inflationary pressure on the economy.

a) Increase in taxes:

A high regressive tax structure can successfully reduce the impact of inflation on the economy. An increase in taxes will reduce the disposable income of individuals and their consumption of goods and services. This in turn will lead to fall in prices.

b) Decrease in government expenditure:

A reduction in government expenditure will directly affect aggregate demand. The government will cut the salary of all civil servants and postpone its development projects to reduce the purchasing power of the public.

- **Direct control measures:** Besides monetary and fiscal policies, direct measures are taken for control inflation.

a) **Price control and rationing:**

The government will control the prices of goods by fixing a floor price and ceiling price. If some of the measures fail, rationing is used as a last resort. Rationing is where consumers can purchase limited goods and services using coupons. Rationing is practised in some countries where the government controls essential goods

b) Anti-hoarding campaign:

This arises when reports are made against producers and consumers who store goods unnecessarily because such storing can cause artificial shortage and push prices up.

d) Compulsory saving:

To control inflation, it is essential to introduce a compulsory savings plan. This could be by way of deduction from salary of workers that is credited to workers' accounts. This deduction is known as Employees Provident Fund(EPF),which is 10% or like so amount, deducted every month.

National Income

- National income is the aggregate flow of goods and services in a country over a period of time, usually for a year. The total amount of income accruing to a country from economic activities in a year's time is known as national income. It includes payments made to all resources in the form of wages, interest, rent and profits.

- From the modern point of view, Simon Kuznets has defined national income as "the net output of commodities and services flowing during the year from the country's productive system in the hands of the ultimate consumers."

Concepts of National Income:

- **1.** Gross Domestic Product(GDP): GDP is the total value of goods and services produced within the country during a year. This is calculated at market prices and is known as GDP at market prices. Dernberg defines GDP at market price as “the market value of the output of final goods and services produced in the domestic territory of a country during an accounting year.”
- GDP excludes goods and services produced by Indian citizens working overseas as well as international goods. The output produced by foreign workers in India such as by national of other country working here like Nepalese or Indonesians, will be included in the GDP. The net income from abroad will make the difference between gross domestic product and gross national product.

- **2.** Gross National Product(GNP): GNP is defined as the total market value of all final goods and services produced by the residents of a country during a given period of time. In other words, GNP is the total amount of income earned by nationals of the country, regardless of where they are. For example income earned by Indians working abroad in countries like Singapore, Japan or America etc. will be included in the GNP. However income earned by foreign workers in India will not be included in the GNP.
- While calculating the GNP only final goods and services that satisfy consumption needs will be included and the value of intermediate goods and input will be excluded to avoid double accounting.

- GNP can be defined as the sum of the gross domestic product(GDP) and the net factor income from abroad. Net factor income from abroad is the difference between the income received from abroad and the income paid abroad. In other words to calculate the GNP we must add net factor income abroad to the GDP.
- GNP = GDP + net factor income from abroad
- GNP = GDP + [factor income received from abroad – factor income paid abroad]

- **3. Net National Product (NNP):** Net National Product is defined as the market value of the net output of final goods and services produced by a nation during a year. In other words, Net National Product(NNP) is GNP minus the value of capital consumption or depreciation during the year. NNP is also referred to as the national income at market prices.
- NNP at market price = GNP at market price - depreciation

METHODS OF MEASUREING NATINAL INCOME

- There are three methods of measuring national income because national income is capable of being viewed from three dimensions-- total output, total income or total expenditure. National income can be defined from any of these three dimensions.
- The flow of income of a household, firm, government and the rest of the world is circular in nature. From the circular flow, we can derive the following dimesions, assuming there are no leakages:
- a) All household income must be equal to household expenditure on goods and services.
- b) Value of output must be equal to total expenditure on goods and services.
- c) Household income must be equal to value of output.
- Therefore, Income = Product = Expenditure

- **This fundamental identity of 'Income = Product = Expenditure' gives the same results when we measure national income. The three methods measure the same flow.**
- **National Income can be calculated using three approaches:**
- **I) Expenditure approach**
- **ii) Income approach**
- **iii) Product approach**

1. Expenditure Approach

- In this method,national income is obtained by adding all the expenditure on goods and services in a year. According to this approach, the national expenditure is made up of four economic sectors:
- 1. Personal Consumption (C) –Personal consumption includes the purchase of goods and services produced by firms, individuals or households. The goods that are purchased by individuals or households would include items such as personal computers, shoes, compact disks, etc., as well as services such as paying insurance premiums, obtaining legal advice, seeking medical services etc.
- 2. Investment (I) – Investments refer to the purchase of capital goods by firms for use in production and also changes in the firms' inventories. Inventories refer to the stocks of raw materials, semi-finished products and unsold final products that are retained by firms over a year.

3. Government Spending (G)-- Government spending is the expenditure made by federal, state and local governments for final goods and services. The purchase of government goods and services includes the cost of providing national defence, construction of new buildings such as schools and hospitals, and the payment of salaries to public servants.

- Transfer payment is not included in government expenditure because it does not represent the purchase of goods and services. Rather it is a transfer of income from the government to individuals or households.

- 4. Net Exports (X – M)-- Net exports is the difference between what a country, say India, earns by exporting goods and services to other countries (China, USA etc.,) and what it pays for goods and services that are imported from other countries. In other words, we can say that net exports are *the difference between the value of exports and the value of imports*.
- In this expenditure method, Gross Domestic Product (GDP) is calculated by adding up all the four items of expenditure as follows:
- GDP at market price = C +I+G+(X-M)

2. Income Approach

- Income approach measures national income by adding all the various types of income paid to firms and households. In this form of wages for labour, rent to land, interest for capital and profit to entrepreneurs.
- In the income approach, all the figures are in *factor cost* because only earnings of factors of production can be calculated. The major income components in national income are :
- 1. Wages and salaries – Wages and salaries are the income received by labour from firms for services rendered. The income also includes fringe benefits, such as social security or pension fund contributions.

- **2**. Net interest-- Net interest is the difference between total interest payments received by households for borrowed funds that finance investment purchases and total interest payments made by households on their own borrowings for investment purposes.
- 3. Rental Income-- Rental income is the payment for rented inputs. The supplier can earn an income from suppling land and buildings for the use of others.
- 4. Profits-- Profits refer to corporate profits earned by business corporations or payment of dividends to shareholders.
- In the income method, Gross Domestic Product(GDP) is calculated by adding up all the items of income earned from factors of production.
- GDP = wages+ salaried + rent + profit+ interest+dividend.

3. Product Approach

- *Under product approach, national income is measured by net value of all final goods and services produced by a nation during a year*. The product approach is also known as Output approach or Value Added Approach.
- In calculating gross domestic product under the product approach, only the money value of final goods and services are included in the calculation. The value of raw materials and intermediate goods are subtracted from the value of gross domestic product to avoid double counting.
- In many developing countries, there are three sectors contributing to the gross domestic product (GDP).

- **1.** The primary sector comprising Mining and Quarrying; Agriculture, Forestry and Fishing.
- 2. The secondary sector comprising Manufacturing and Construction.
- 3. The Tertiary sector comprising Electricity, Gas and Water; Wholesale and Retail Trade; Finance, Insurance, Real Estate and Business services; Transport, Storage and Communications, Government services and other services.
- Final products from all these sectors are added up to obtain Gross Domestic Product (GDP) under the Product Approach or the Value Added Approach.
- GDP = Final product in the economy