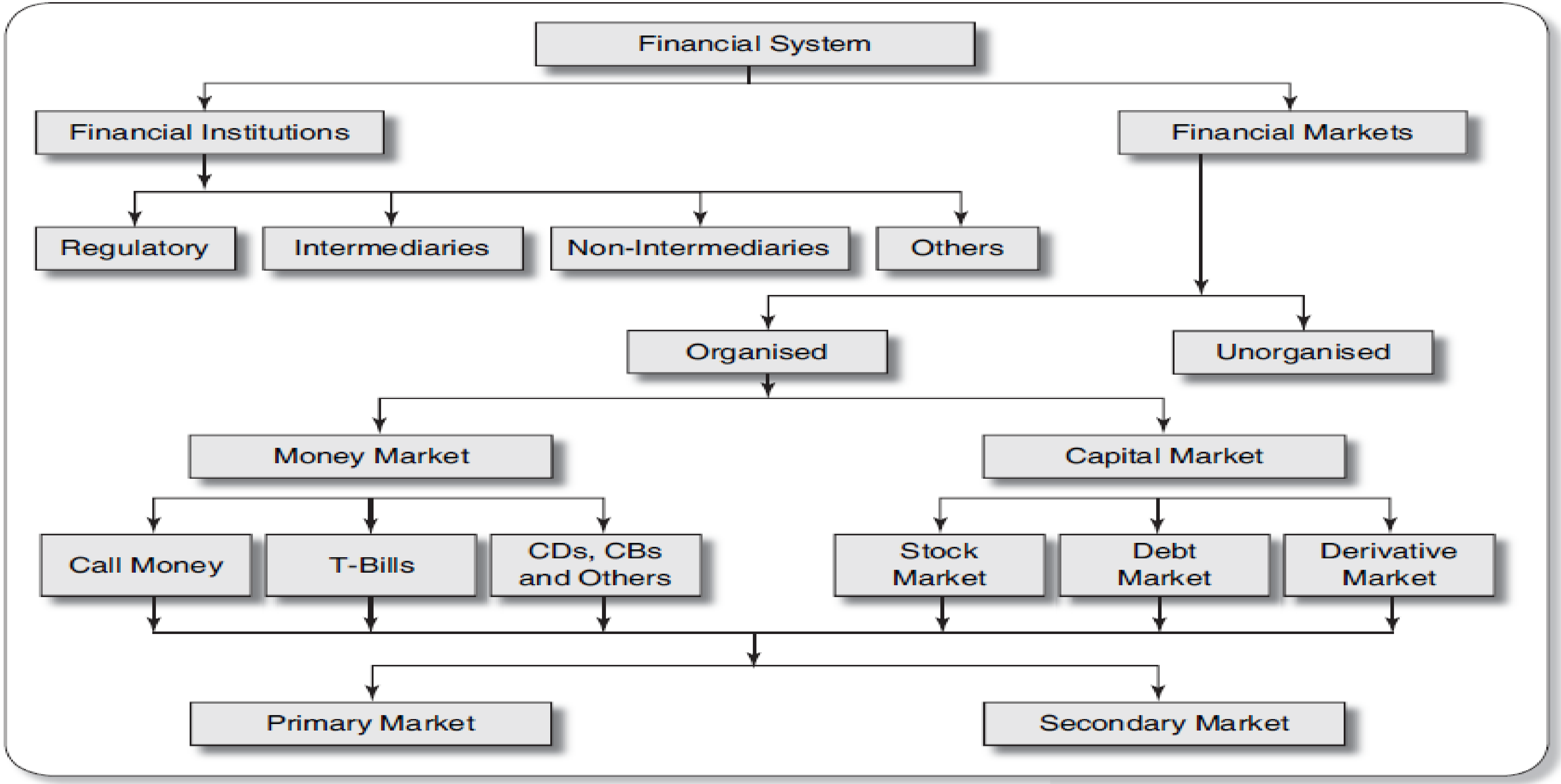
Overview of Financial System

What is Financial System?

- The financial system deals with the financial transactions and the exchange of money between savers, investors, lenders and borrowers.
- Financial systems are made of different intricate and complex models that link financial institutions and markets to provide financial services for various stakeholders operating in the financial system like depositors, lenders, borrowers, government and others.

Structure of the Financial System



Classification of Financial Institutions

- Banking and Non-Banking
  - Banks provide transactions services
  - Create deposits or credit
  - Subject to legal reserve requirements
  - Can advance credit by creating claims against themselves
  - other institutions can lend only out of resources put at their disposal by the savers
  - Examples of non-banking financial institutions are Life Insurance Corporation (LIC), Mutual Fund Institutions (MFIs), and other Non-Banking Financial Companies (NBFCs).
  - According to Sayers banks are "creators" of credit, and non-banking institutions are "purveyors" of credit

Classification of Financial Institutions Cont…

- Intermediaries Vs. Non-Intermediaries
  - Intermediaries intermediate between savers and investors;
  - They lend money as well as mobilise savings;
  - Their liabilities are towards the ultimate savers, while their assets are from the investors or borrowers
  - All banking institutions are intermediaries and LIC and GIC are some of the non-banking financial intermediaries (NBFI)
  - Non-intermediary institutions do the loan business but their resources are not directly obtained from the savers Example: IFC, NABARD etc.

Classification of Financial Markets

- **Money and Capital Markets**
  - This conventional distinction is based on the differences in the period of maturity of financial assets issued in these markets
  - While the money markets deal in the short-term claims (with a period of maturity of one year or less), the capital markets does so in the long-term (maturity period above 1 year) claims
- **Primary and Secondary Markets**
  - Primary markets deal in the new financial claims or new securities
  - Secondary markets deal in securities already issued or existing or outstanding

Equilibrium in Financial System

Equilibrium is established when the expected demand for funds (credit) for short-term & long-term investment matches with the planned supply of funds generated out of savings and credit creation

Determinants of Supply of Funds

- Aggregate savings by the household sector, business sector and the government sector
- Level of current and expected income
- Cyclical changes in income, age wise variations in income, distribution of income in the economy, degree of certainty of income
- Wealth
- Inflation
- Desire to provide for old age, family members, contingencies
- Rate of interest
- Availability of savings media with preferred investment characteristics
- Development of banks and other financial institutions

Determinants of Demand for Funds

- Investment in fixed and circulating (working) capital
  - The current level of capital stock
  - Capacity utilisation
  - The desired capital stock, which is influenced by business expectations (prospects) regarding future demand for goods (sales), prices, Government policies, and profitability
  - Availability of internal funds
  - Cost of funds
  - Technological changes.
- Demand for consumer durables
  - The demand for consumer durables depends upon (a) changes in tastes and preferences, (b) fashion, (c) demonstration effect, and (d) cost of funds.
- Investment in housing

Financial Sector Development and Economic Growth

- The Classical Prior Voluntary Saving Theory
- Credit Creation Theory
- Forced Saving or Inflationary Financing Theory
- Financial Repression Theory
- Financial Liberalisation Theory

Prior Savings Theory

- Saving as a prerequisite or a determinant of investment
- It is averse to inflation, it advocates control of inflation
- Suggests a policy of reasonably high positive real interest rates to encourage savings by the public
- Financial institutions promote development by offering the following "transformation services or functions
  - Liability-Asset Transformation
  - Size-Transformation
  - Risk-Transformation
  - Maturity Transformation

Credit Creation Theory

- Financial system plays a positive and catalytic role by providing finance or credit through creation of credit in anticipation of savings
- Independence of investment from saving in a given period of time
- Equality in savings and investments
- Investment out of created credit results in a prompt income generation

Theory of Forced Savings

- Investment is not determined by savings
- Investments can be increased autonomously through monetary expansion
- Channels through which monetary expansion affects economic growth:
- If the resources are unemployed, it would increase aggregate demand, output, and savings
- Portfolio Shift Effect (if resources are fully employed)
- Income Distribution Effect (increasing savings through profit)
- Inflation Tax Effect

Financial Regulation Theory

- Financial markets are prone to market failure
- Certain forms of Government intervention are required
- The lowering of interest rates through government intervention improves the average quality of the pool of loan applications, and improves the efficiency with which capital is allocated
- Direct credit programmes can encourage lending to sectors which are usually shunned by the market
- Government intervention provides that public good
- Stable Payment system

Financial Liberalisation Theory

- Increase in interest rates on a variety of financial assets as they would adjust to their competitive free-market equilibrium level
- Increase in saving, reduction in the holding of real assets, and increase in financial deepening
- Expansion in the supply of real credit
- Increase in investment
- Increase in average productivity of investment
- Increase in allocative efficiency of investment.

Aggregate Financial Development Indicators

- Finance Ratio (FR): the ratio of total issues of primary and secondary claims to national income
- Financial Inter-relation Ratio (FIR): the ratio of financial assets to physical assets in the economy
- New Issue Ratio (NIR): the ratio of primary issues to the physical capital formation which indicates how far investment has been financed by direct issues to the savers by the investing sectors.
- Intermediation Ratio (IR): the ratio of secondary issues to primary issues, which indicates the extent of development of financial institutions as mobilisers of funds relative to real sectors as direct mobilisers of funds. It indicates institutionalisation of the financial activity in the economy.
- The ratio of money to national income: the higher this ratio the greater the financial development because it indicates the extent of monetisation and the size of exchange economy in the country.

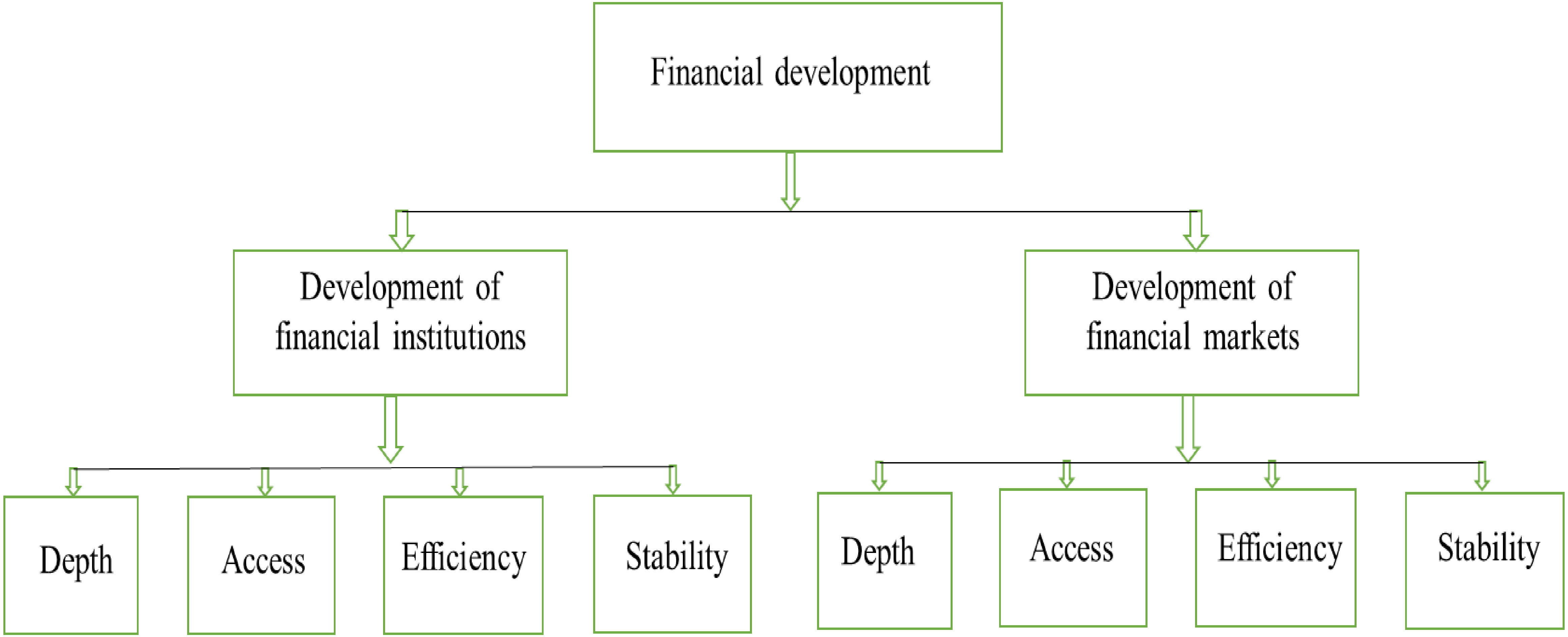
Aggregate Financial Development Indicators Cont..

- The proportion of current account deficit which is financed by market related flows
- Developed financial sector is fully integrated (is not segmented) domestically as well as internationally
- Lower the transaction cost and information cost
- Private banking should be developed
- Strong and effective system of supervision, inspection, auditing, and regulation

Aggregate Financial Development Indicators Cont..

- Presence of strong, active, large-sized non-bank financial sector comprising stock market, debt market, insurance companies, pension funds, mutual funds, etc.
- High level of current and capital account openness/convertibility and minimum restrictions on foreign ownership of assets
- Effective and quick enforcement of financial contracts, and recovery of loans
- Use of indirect rather than direct techniques of monetary policy

Dimensions of Financial Sector Development



Indicators

Category	Indicator	
	Financial Institutions	Financial Markets
Depth	Private sector credit to GDP Mutual fund assets to GDP Pension fund assets to GDP Nonbank financial assets to GDP	Stock market capitalization to GDP Stock market total value traded to GDP International debt issues to GDP Outstanding domestic private debt securities to GDP Outstanding domestic public debt securities to GDP
Access	Bank branches per 100000 adults ATMs per 100000 adults Working capital financed by banks	Market capitalization excluding 10 top largest companies to total market capitalization Non-financial corporate bonds to total bonds Investments financed by equity or stock sales
Efficiency	Bank net interest margin Bank lending-deposit spread Non-investment income to total income Return on assets Return on equity Bank cost to income ratio Bank overhead cost to total assets	Stock market turnover ratio (stocks traded to capitalization)
Stability	Bank Z-score Non-performing loans to total loans (%) Bank credit to bank deposits Capital to risk weighted assets	Stock price volatility