Chapter 1: The Financial System: An Introduction

1.1. INTRODUCTION

A robust financial system is crucial for a country's economic growth. It acts as an intermediary, channeling funds from savers to investors in productive assets. This process mobilizes and effectively allocates the nation's limited resources. This system is a complex network of interconnected components—financial institutions, markets, instruments, and services—all working together to facilitate the efficient and effective transfer and allocation of capital.

1.2. Formal and Informal Financial Sectors

Developing countries often exhibit "financial dualism," a coexistence of formal and informal financial sectors. The formal sector comprises organized, institutional, and regulated systems serving modern economic needs, while the informal sector, unorganized and unregulated, caters to traditional and rural economies. This informal sector, arising from economic and social structures and financial repression, offers advantages like low transaction costs and minimal default risk, leading to higher interest rates. Despite these advantages, the formal sector is crucial for its lower intermediation costs and broader access to services for savers and entrepreneurs. A complex interplay exists between the two systems, with participants and activities overlapping. Developing an efficient formal financial system is thus paramount to promoting wider financial inclusion and economic growth.

1.3. The Indian Financial System

The Indian financial system is broadly categorized into formal (organized) and informal (unorganized) sectors. The formal system, overseen by the Ministry of Finance, Reserve Bank of India, Securities and Exchange Board of India, and other regulatory bodies, is well-structured. Conversely, the informal system encompasses various decentralized entities, such as individual moneylenders (neighbors, relatives, etc.), groups operating under their own rules (often called "funds" or "associations"), and partnership firms including local brokers, pawnbrokers, and non-bank financial intermediaries like finance, investment, and chit-fund companies. The spread of banking in rural areas has been instrumental in expanding the reach and influence of the formal financial system in India.

1.4. COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal financial system is structured around four key components: financial institutions, financial markets, financial instruments, and financial services. These segments work together to facilitate the flow of funds between savers and borrowers. Financial institutions, such as banks and investment companies, act as intermediaries, channeling funds from those with surplus capital to those needing it. Financial markets, encompassing stock exchanges and bond markets, provide platforms for trading financial instruments. These instruments, which include stocks, bonds, and derivatives, represent claims on future cash flows or ownership in assets. Finally, financial services, like investment advice and risk management, support the efficient functioning of the entire system.

1.5. Financial Institutions

Financial institutions act as intermediaries, mobilizing savings and efficiently allocating funds. They are broadly categorized as banking and non-banking institutions. Banking institutions, such as commercial banks, create and provide credit, with their liabilities often forming part of the money supply. Non-banking institutions, including developmental financial institutions (DFIs), non-banking financial companies (NBFCs), and housing finance companies (HFCs), also provide credit, though their liabilities may not directly contribute to the money supply. Specialized institutions like term-finance institutions (e.g., IDBI, ICICI, IFCI) and specialized finance institutions (e.g., EXIM Bank, IDFC) cater to specific sectors or needs. Further, sectoral institutions such as NABARD and NHB focus on agriculture and housing, respectively. Investment institutions, comprising mutual funds (like UTI) and insurance companies (like LIC and GIC), play crucial roles. Finally, state-level institutions, such as State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs), are government-owned and managed. The post-reform era has witnessed significant changes, with banks expanding into non-banking activities and financial institutions taking on banking functions. The reliance on financial markets for funds has become more common across the spectrum of financial institutions.