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The Financial System: An Introduction

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Meaning of a financial system*
2. *Components of a financial system*
3. *Functions of a financial system*
4. *Key elements of a well-functioning financial system*
5. *Bank-based and market-based financial systems*
6. *Nature and role of financial institutions and financial markets*
7. *Link between money markets and capital markets*
8. *Link between primary markets and secondary markets*
9. *Functions and characteristics of financial markets*

INTRODUCTION

A financial system plays a vital role in the economic growth of a country. It intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. It mobilizes and usefully allocates scarce resources of a country.

A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.

Formal and Informal Financial Sectors

The financial systems of most developing countries are characterized by coexistence and cooperation between the formal and informal financial sectors. This coexistence of these two sectors is commonly referred to as 'financial dualism.' The formal financial sector is characterized by the presence of an organized, institutional, and regulated system which caters to the financial needs of the modern spheres of economy; the informal financial sector is an unorganized, non-institutional, and non-regulated system dealing with the traditional and rural spheres of the economy.

The informal financial sector has emerged as a result of the intrinsic dualism of economic and social structures in developing countries, and financial repression which inhibits the certain deprived sections of society from accessing funds. The informal system is characterized by flexibility of operations and interface relationships between the creditor and the debtor. The advantages are: low transaction costs, minimal default risk, and transparency of procedures. Due to these advantages, a wide range and higher rates of interest prevail in the informal sector.

An interpenetration is found between the formal and informal systems in terms of operations, participants, and nature of activities which, in turn, have led to their coexistence. A high priority should be accorded to the development of an efficient formal financial system as it can offer lower intermediation costs and services to a wide base of savers and entrepreneurs.

Informal Financial System

Advantages
- Low transaction costs
- Minimum default risk
- Transparency of procedures

Disadvantages
- Wide range of interest rates
- Higher rates of interest
- Unregulated

The Indian Financial System

The Indian financial system can also be broadly classified into the formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. The informal financial system consists of:

- Individual moneylenders such as neighbours, relatives, landlords, traders, and storeowners.
- Groups of persons operating as 'funds' or 'associations.' These groups function under a system of their own rules and use names such as 'fixed fund,' 'association,' and 'saving club.'
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

In India, the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services (refer Figure 1.1).

Financial Institutions

Classification of Financial Institutions

- Banking and non-banking
- Term finance
- Specialized
- Sectoral
- Investment
- State-level

These are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner.

Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs), and non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), the Industrial Financial Corporation of India (IFCI), the Small Industries Development Bank of India (SIDBI), and the Industrial Investment Bank of India (IIBI).

Financial institutions can be specialized finance institutions like the Export Import Bank of India (EXIM), the Tourism Finance Corporation of India (TFCI), ICICI Venture, the Infrastructure Development Finance Company (IDFC), and sectoral financial institutions such as the National Bank for Agricultural and Rural Development (NABARD) and the National Housing Bank (NHB).

Investment institutions in the business of mutual funds Unit Trust of India (UTI), public sector and private sector mutual funds and insurance activity of Life Insurance Corporation (LIC), General Insurance Corporation (GIC) and its subsidiaries are classified as financial institutions.

There are state-level financial institutions such as the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) which are owned and managed by the State governments.

In the post-reforms era, the role and nature of activity of these financial institutions have undergone a tremendous change. Banks have now undertaken non-bank activities and financial institutions have taken up banking functions. Most of the financial institutions now resort to financial markets for raising funds.

Financial Markets

Types

- Money market
- Capital market

Segments

- Primary market
- Secondary market

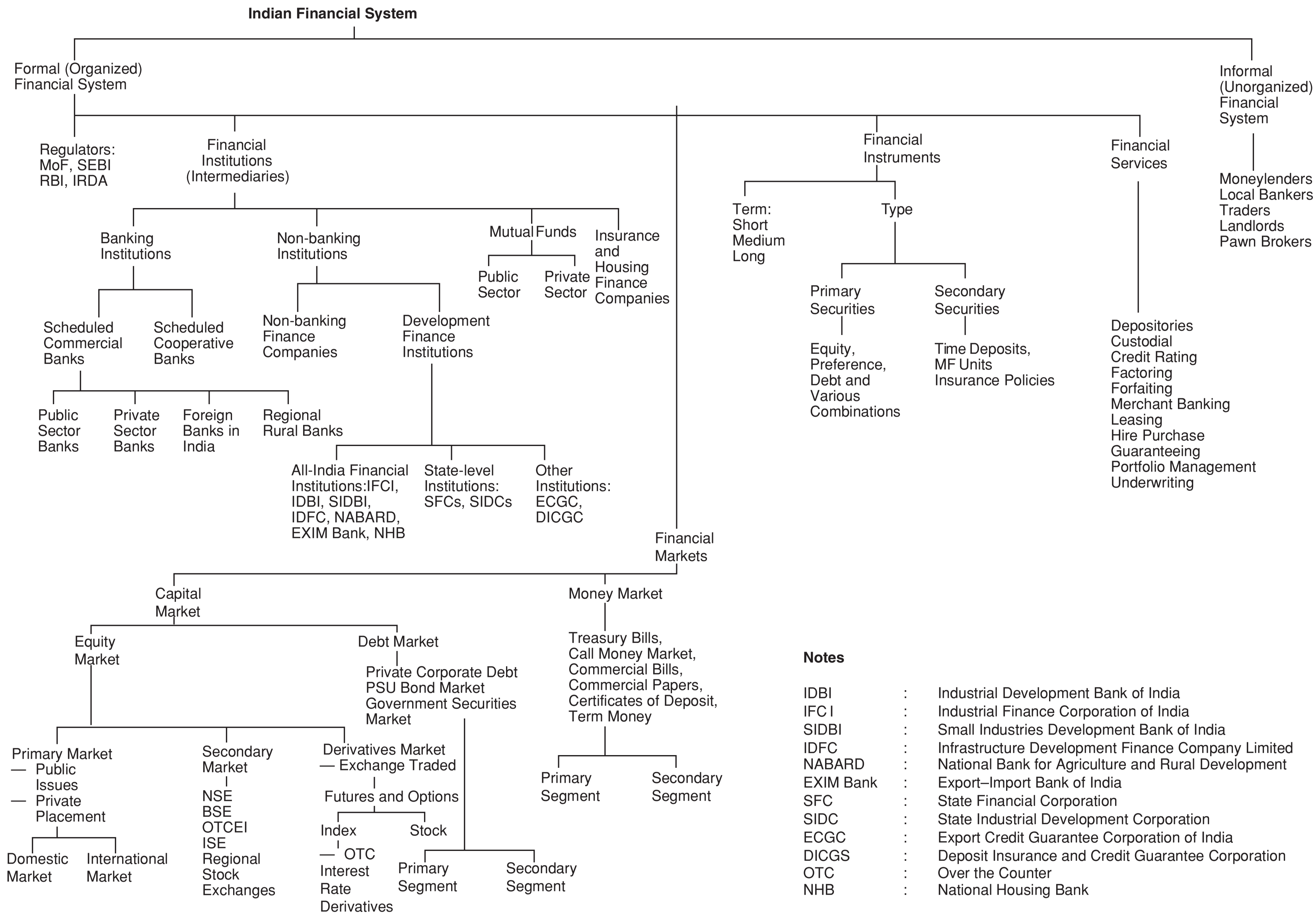
Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.

The main organized financial markets in India are the money market and the capital market. The first is a market for short-term securities while the second is a market for long-term securities, *i.e.*, securities having a maturity period of one year or more.

Financial markets can also be classified as primary and secondary markets. While the primary market deals with new issues, the secondary market is meant for trading in outstanding or existing securities. There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market. The government securities market is an OTC market. In an OTC market, spot trades are negotiated and traded for immediate delivery and payment while in the exchange-traded market, trading takes place over a trading cycle in stock exchanges. Recently, the derivatives market (exchange traded) has come into existence.

Financial Instruments

A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term ‘and/or’ implies that either of the payments will be sufficient but both of them may be promised. Financial instruments represent paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organized markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing risk.



Notes

IDBI	:	Industrial Development Bank of India
IFC I	:	Industrial Finance Corporation of India
SIDBI	:	Small Industries Development Bank of India
IDFC	:	Infrastructure Development Finance Company Limited
NABARD	:	National Bank for Agriculture and Rural Development
EXIM Bank	:	Export–Import Bank of India
SFC	:	State Financial Corporation
SIDC	:	State Industrial Development Corporation
ECGC	:	Export Credit Guarantee Corporation of India
DICGS	:	Deposit Insurance and Credit Guarantee Corporation
OTC	:	Over the Counter
NHB	:	National Housing Bank

Figure 1.1 Indian Financial System

Types of Financial Securities

- Primary
- Secondary

Distinct Features

- Marketable
- Tradeable
- Tailor-made

Different types of financial instruments can be designed to suit the risk and return preferences of different classes of investors.

Savings and investments are linked through a wide variety of complex financial instruments known as 'securities.' Securities are defined in the Securities Contracts Regulation Act (SCRA), 1956 as including shares, scrips, stocks, bonds, debentures, debenture stocks or other marketable securities of a similar nature or of any incorporated company or body corporate, government securities, derivatives of securities, units of collective investment scheme, security receipts, interest and rights in securities, or any other instruments so declared by the central government.

Financial securities are financial instruments that are negotiable and tradeable. Financial securities may be primary or secondary securities. Primary securities are also termed as direct securities as they are directly issued by the ultimate borrowers of funds to the ultimate savers. Examples of primary or direct securities include equity shares and debentures. Secondary securities are also referred to as indirect securities, as they are issued by the financial intermediaries to the ultimate savers. Bank deposits, mutual fund units, and insurance policies are secondary securities.

Financial instruments differ in terms of marketability, liquidity, reversibility, type of options, return, risk, and transaction costs. Financial instruments help financial markets and financial intermediaries to perform the important role of channelizing funds from lenders to borrowers. Availability of different varieties of financial instruments helps financial intermediaries to improve their own risk management.

Financial Services

Need of Financial Services for

- Borrowing and funding
- Lending and investing
- Buying and selling securities
- Making and enabling
- Payments and settlements
- Managing risk

These are those that help with borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets. The major categories of financial services are funds intermediation, payments mechanism, provision of liquidity, risk management, and financial engineering.

Funds intermediating services link the saver and borrower which, in turn, leads to capital formation. New channels of financial intermediation have come into existence as a result of information technology. Payment services enable quick, safe, and convenient transfer of funds and settlement of transactions.

Liquidity is essential for the smooth functioning of a financial system. Financial liquidity of financial claims is enhanced through trading in securities. Liquidity is provided by brokers who act as dealers by assisting sellers and buyers and also by market makers who provide buy and sell quotes.

Financial services are necessary for the management of risk in the increasingly complex global economy. They enable risk transfer and protection from risk. Risk can be defined as a chance of loss. Risk transfer of services help the financial market participants to move unwanted risks to others who will accept it. The speculators who take on the risk need a trading platform to transfer this risk to other speculators. In addition, market participants need financial insurance to protect themselves from various types of risks such as interest rate fluctuations and exchange rate risk.

Growing competition and advances in communication and technology have forced firms to look for innovative ways for value creation. Financial engineering presents opportunities for value creation. These services refer to the process of designing, developing, and implementing innovative solutions for unique needs in funding, investing, and risk management. Restructuring of assets and/or liabilities, off balance sheet items, development of synthetic securities, and repackaging of financial claims are some examples of financial engineering.

The producers of these financial services are financial intermediaries, such as, banks, insurance companies, mutual funds, and stock exchanges. Financial intermediaries provide key financial services such as merchant banking, leasing, hire purchase, and credit-rating. Financial services rendered by the financial intermediaries bridge the gap between lack of knowledge on the part of investors and the increasing sophistication of financial instruments and markets. These financial services are vital for creation of firms, industrial expansion, and economic growth.

Before investors lend money, they need to be reassured that it is safe to exchange securities for funds. The financial regulator who regulates the conduct of the market and intermediaries to protect the investors' interests provides this reassurance. The regulator regulates the conduct of issuers of securities and the intermediaries to protect the interests of investors in securities and increases their confidence in markets which, in turn, helps in the growth and development of the financial system. Regulation is necessary not only to develop a system, but a system once developed needs to be regulated. The RBI regulates the money market and the SEBI regulates the capital market. The securities market is regulated by the Department of Economic Affairs (DEA), the Department of Company Affairs (DCA), the RBI, and the SEBI. A high-level committee on capital and financial markets coordinates the activities of these agencies.

Interaction Among Financial System Components

The four financial system components discussed do not function in isolation. They are interdependent and interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.

Interaction Among the Components

- Interdependent
- Interactive
- Close links
- Competing with each other

Financial institutions or intermediaries mobilize savings by issuing different types of financial instruments which are traded in the financial markets. To facilitate the credit-allocation process, these institutions acquire specialization and render specialized financial services.

Financial intermediaries have close links with the financial markets in the economy. Financial institutions acquire, hold, and trade financial securities which not only help in the credit-allocation process but also make the financial markets larger, more liquid, stable, and diversified. Financial intermediaries rely on financial markets to raise funds whenever the need arises. This increases the competition between financial markets and financial intermediaries for attracting investors and borrowers. The development of new sophisticated markets has led to the development of complex securities and portfolios. The evaluation of these complex securities, portfolios, and strategies requires financial expertise which financial intermediaries provide through financial services.

Financial markets have also made an impact on the functioning of financial intermediaries such as banks and financial institutions. The latter are, today, radically changed entities as the bulk of the service fees and non-interest income that they derive is directly or indirectly linked to financial market-related activities.

Moreover, liquid and broad markets make financial instruments a more attractive avenue for savings, and financial services may encourage further savings if the net returns to investors are raised or increased.

FUNCTIONS OF A FINANCIAL SYSTEM

One of the important functions of a financial system is to link the savers and investors and, thereby, help in mobilizing and allocating the savings efficiently and effectively. By acting as an efficient conduit for allocation of resources, it permits continuous upgradation of technologies for promoting growth on a sustained basis.

Functions of a Financial System

- Mobilize and allocate savings
- Monitor corporate performance
- Provide payment and settlement systems
- Optimum allocation of risk-bearing and reduction
- Disseminate price-related information
- Offer portfolio adjustment facility
- Lower the cost of transactions
- Promote the process of financial deepening and broadening

A financial system not only helps in selecting projects to be funded but also inspires the operators to monitor the performance of the investment. Financial markets and institutions help to monitor corporate performance and exert corporate control through the threat of hostile takeovers for underperforming firms.

It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries. Payment and settlement systems play an important role to ensure that funds move safely, quickly, and in a timely manner. An efficient payment and settlement system contributes to the operating and allocation efficiencies of the financial system and thus, overall economic growth. Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector. Banks provide this mechanism by offering a means of payment facility based upon cheques, promissory notes, credit and debit cards. This payment mechanism is now increasingly through electronic means. The clearing and settlements mechanism of the stock markets is done through depositories and clearing corporations.

One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilizing savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits. It reduces risk by laying down rules governing the operation of the system. Risk reduction is achieved by holding diversified portfolios and screening of borrowers. Market participants gain protection from unexpected losses by buying financial insurance services. Risk is traded in the financial markets through financial instruments such as derivatives. Derivatives are risk shifting devices, they shift risk from those who have it but may not want it to those who are willing to take it.

A financial system also makes available price-related information which is a valuable assistance to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular asset. This information dissemination enables a quick valuation of financial assets. Moreover, by influencing the market price of a firm's debt and equity instruments, this process of valuation guides the management as to whether their actions are consistent with the objective of shareholder wealth maximization. In addition, a financial system also minimises situations where the information is asymmetric and likely to affect motivations among operators when one party has the information and the other party does not. It also reduces the cost of gathering and analysing information to assist operators in taking decisions carefully.

A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial depth is an important measure of financial system development as it measures the size of the financial intermediary sector. Depth equals the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries divided by the GDP). Financial broadening refers to building an increasing number and variety of participants and instruments.

KEY ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

Basic Elements of a Well-functioning Financial System

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- Sound banking system
- Information system
- Well-functioning securities market

The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) a central bank, (v) a sound banking system, (vi) an information system, and (vii) a well-functioning securities market.

Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.

Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.

Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments world over led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.

A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.

A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.

Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilizing and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

FINANCIAL SYSTEM DESIGNS

Financial System Designs

- Bank-based
- Market-based

A financial system is a vertical arrangement of a well-integrated chain of financial markets and institutions that provide financial intermediation. Different designs of financial systems are found in different countries. The structure of the economy, its pattern of evolution, and political, technical, and cultural differences affect the design (type) of financial system.

Two prominent polar designs can be identified among the variety that exists. At one extreme is the bank-dominated system, such as in Germany, where a few large banks play a dominant role and the stock market is not important. At the other extreme is the market-dominated financial system, as in the US, where financial markets play an important role while the banking industry is much less concentrated. The other major industrial countries fall in between these two extremes (Figure 1.2).

Demirguc Kunt and Levine (1999) have provided explanations of bank-based and market-based financial systems. In bank-based financial systems, banks play a pivotal role in mobilizing savings, allocating capital, overseeing the investment decisions of corporate managers, and providing risk-management facilities. In market-based financial systems, the securities markets share centre stage with banks in mobilizing the society's savings for firms, exerting corporate control, and easing risk management.

Bank-based systems tend to be stronger in countries where governments have a direct hand in industrial development. In India, banks have traditionally been the dominant entities of financial intermediation. The nationalization of banks, an administered interest rate regime, and the government policy of favouring banks led to the predominance of a bank-based financial system.

Demirguc Kunt and Levine, using a database of 150 countries, have classified countries according to the structure and level of financial development (Table 1.1).

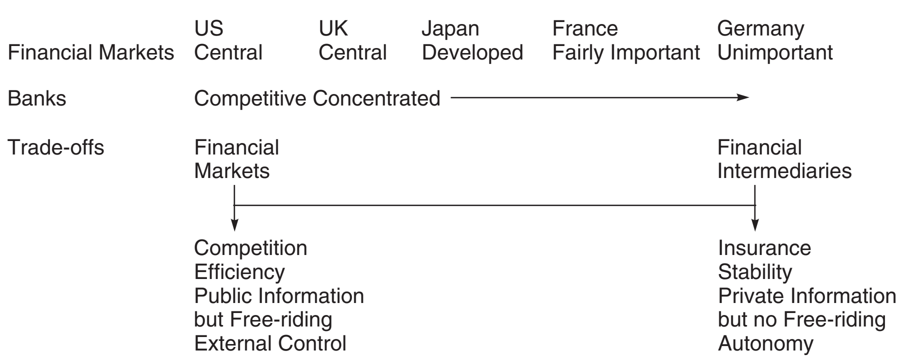
Their comparison of financial systems across different income groups reveals several patterns. First, financial systems are, on an average, more developed in rich countries. There is a tendency for a financial system to become more market-oriented as the country becomes richer. Second, countries with a common-law tradition, strong protection of shareholders' rights, and low levels of corruption tend to be more market-based and have well-developed financial systems.

Arnold and Walz (2000) have attempted to identify factors leading to the emergence of bank-based or market-based financial systems. When problems relating to information persist but banks are competent

TABLE 1.1 Classification of Financial Structure and Level of Development of Select Economies

Extent of Development	*Bank-based*	*Market-based*
Developed	Japan, Germany, France, Italy	US, UK, Singapore, Malaysia, Korea
Under-developed	Argentina, Pakistan, Sri Lanka, Bangladesh	Brazil, Mexico, the Philippines, Turkey

Source: Demirguc Kunt, A. and R. Levine (1999), Bank-based and Market-based Financial System: Cross-Country Comparisons, World Bank Policy Research Working Paper No. 2143.



Source: Allen and Gale (2000), *Comparing Financial Systems*, MIT Press, Cambridge, Mass.

Figure 1.2 Overview and Trade-offs of Financial Systems

Market-based Financial System

Advantages
- Provides attractive terms to both investors and borrowers
- Facilitates diversification
- Allows risk-sharing
- Allows financing of new technologies

Drawbacks
- Prone to instability
- Exposure to market risk
- Free-rider problem

enough right from the beginning and, with the passage of time, learn through experience to become more productive, they come to dominate the financial system. Conversely, if banks are initially incompetent and fail to improve themselves by experience, the bank-based system gives way to the growth of a market-based financial system.

Given these two types of financial systems, questions arise about the advantages and disadvantages of a bank-based financial system vis-a-vis a market-based financial system. Some researchers suggest that markets are more effective at providing financial services while some tout the advantages of intermediaries.

Proponents of the market-based view argue that efficiency is associated with the functioning of competitive markets. Financial markets are attractive as they provide the best terms to both investors and borrowers. Stock markets facilitate diversification and allow efficient risk-sharing. They provide incentives to gather information that is reflected in stock prices and these prices, in turn, provide signals for an efficient allocation of investment. An important area in which financial markets perform differently from financial intermediaries is in situations where a diversity of opinion is important, such as the financing of new technologies or when an unusual decision has to be made. Hence, in emerging industries with significant financial and technological risks, a market-based system may be preferable.

The drawbacks of the market-based system are that it is more prone to instability, its investors are exposed to market risks, and that there is a free-rider problem. The last drawback arises when no individual is willing to contribute towards the cost of something but hopes that someone else will bear the cost. This problem arises whenever there is a public good and separation of ownership from control. For example, shareholders take little interest in the management of their companies, hoping someone else will monitor the executives. In a market-based system, the free-rider problem blunts the incentives to gather information.

On the other hand, a bank-based system is perceived to be more stable, as the relationship with parties is relatively close. This leads to the formation of tailor-made contracts and financial products and efficient inter-temporal risk-sharing. Financial intermediaries can eliminate the risks that cannot be diversified at a given point of time but can be averaged over time through inter-temporal smoothing of asset returns. This requires that investors accept lower returns than what the market offers in some periods in order to get higher returns in other periods. This provides an insurance to investors who would otherwise be forced to liquidate assets at disadvantageous prices.

Bank-based Financial System

Advantages
- Close relationship with parties
- Provides tailor-made contracts
- Efficient intertemporal risk-sharing
- No free-rider problem

Drawbacks
- Retards innovation and growth
- Impedes competition

The banking system avoids some of the information deficiencies associated with the securities markets. The free-rider problem is eliminated as private incentives to gather information are higher in the case of a bank-based system. Moreover, banks can perform screening and monitoring functions on behalf of the investors; these functions, left to themselves, can be undertaken only at a high cost.

The greatest drawback of a bank-based system is that it retards innovation and growth as banks have an inherent preference for low-risk, low-return projects. Moreover, powerful banks may collude with firm managers against other investors, which, in some cases, could impede competition, effective corporate control, and entry of new firms.

The current trend is a preference for the market-based system. France and Japan have reformed their markets to make them more competitive. It is partly due to the growing volume of banking activity in the financial markets. The European Union is moving towards a single unified market to increase its global competitiveness. In India also, the role of stock markets has gained prominence. The government has put in substantial efforts to reform the financial markets. The Indian equity market, now, is at par with some of the developed markets of the world. Moreover, the ratio of market capitalization to

Box 1.1 Evolution of Financial Systems

In the 1950s and 1960s, Gurley and Shaw (1955, 1960, 1967) and Goldsmith (1969) discussed the stages in the evolution of financial systems. According to them, there is a link between per capita income and the development of a financial system. At low levels of development, most investment is self-financed and financial intermediaries do not exist, as the costs of financial intermediation are high relative to benefits. As countries develop and per capita income increases, bilateral borrowing and lending take place leading to the birth of financial intermediaries. The number of financial intermediaries grows with further increases in per capita income. Among the financial intermediaries, banks tend to become larger and prominent in financial investment. As countries expand economically, non-bank financial intermediaries and stock markets grow in size and tend to become more active and efficient relative to banks. There is a general tendency for financial systems to become more market-oriented as countries become richer.

assets of scheduled commercial banks has risen sharply from 28.4 per cent in March 1991 to 79.3 per cent in March 2000. The relative share of banks in the aggregate financial assets of banks and financial institutions taken together, which stood at nearly three-fourths in the early 1980s, is now hovering around the two-thirds mark since the 1990s. This implies that there is considerable potential for growth in market financing.

Allen and Gale (2000) have put forward two explanations for the universal popularity of financial markets: (i) government intervention is regarded as a negative factor and government failures are as important a problem as market failures, (ii) economic theory, pertaining to firms, stresses the effectiveness of markets in allocating resources.

Empiral analysis in various researches do not emphatically suggest the superiority of one system over the other. Whatever be the type of financial system, both financial intermediaries and financial markets play a crucial role in the development of a sound financial system. Both systems can coexist as they encourage competition, reduce transaction costs, and improve resource allocation within the economy, leading to the development of a balanced financial system.

NATURE AND ROLE OF FINANCIAL INSTITUTIONS (INTERMEDIARIES) AND FINANCIAL MARKETS

Financial institutions (intermediaries) are business organizations serving as a link between savers and investors and so help in the credit-allocation process. Good financial institutions are vital to the functioning of an economy. If finance were to be described as the circulatory system of the economy, financial institutions are its brain. They make decisions that tell scarce capital where to go and ensure that it is used most efficiently. It has been confirmed by research that countries with developed financial institutions grow faster and countries with weak ones are more likely to undergo financial crises.

Financial Institutions Provide Three Transformation Services

- Liability, asset, and size transformation
- Maturity transformation
- Risk transformation

Lenders and borrowers differ in regard to terms of risk, return, and terms of maturity. Financial institutions assist in resolving this conflict between lenders and borrowers by offering claims against themselves and, in turn, acquiring claims on the borrowers. The former claims are referred to as indirect (secondary) securities and the latter as direct (primary) securities.

Financial institutions provide three transformation services:

- Liability, asset, and size transformation consisting of mobilization of funds, and their allocation by providing large loans on the basis of numerous small deposits.
- Maturity transformation by offering the savers tailor-made short-term claims or liquid deposits and so offering borrowers long-term loans matching the cash-flows generated by their investment.
- Risk transformation by transforming and reducing the risk involved in direct lending by acquiring diversified portfolios.

Through these services, financial institutions are able to tap savings that are unlikely to be acceptable otherwise. Moreover, by facilitating the availability of finance, financial institutions enable the consumer to spend in anticipation of income and the entrepreneur to acquire physical capital.

The role of financial institutions has undergone a tremendous transformation in the 1990s. Besides providing direct loans, many financial institutions have diversified themselves into areas of financial services such as merchant banking, underwriting and issuing guarantees.

Financial Markets

Types
- Money Market—a market for short-term debt instruments
- Capital Market—a market for long-term equity and debt instruments

Segments
- Primary—a market for new issues
- Secondary—a market for trading outstanding issues

Financial Markets

Financial markets are an important component of the financial system. They are a mechanism for the exchange trading of financial products under a policy framework. The participants in the financial markets are the borrowers (issuers of securities), lenders (buyers of securities), and financial intermediaries. Financial markets comprise two distinct types of markets:

- the money market
- the capital market

Money Market A money market is a market for short-term debt instruments (maturity below one year). It is a highly liquid market wherein securities are bought and sold in large denominations to reduce transaction costs. Call money market, certificates of deposit, commercial paper, and treasury bills are the major instruments/segments of the money market.

The functions of a money market are

- to serve as an equilibrating force that redistributes cash balances in accordance with the liquidity needs of the participants;
- to form a basis for the management of liquidity and money in the economy by monetary authorities; and
- to provide reasonable access to the users of short-term money for meeting their requirements at realistic prices.

As it facilitates the conduct of monetary policy, a money market constitutes a very important segment of the financial system.

Capital Market A capital market is a market for long-term securities (equity and debt). The purpose of capital market is to

- mobilize long-term savings to finance long-term investments;
- provide risk capital in the form of equity or quasi-equity to entrepreneurs;
- encourage broader ownership of productive assets;
- provide liquidity with a mechanism enabling the investor to sell financial assets;
- lower the costs of transactions and information; and
- improve the efficiency of capital allocation through a competitive pricing mechanism.

Money Market and Capital Market

There is strong link between the money market and the capital market:

- Often, financial institutions actively involved in the capital market are also involved in the money market.
- Funds raised in the money market are used to provide liquidity for long-term investment and redemption of funds raised in the capital market.
- In the development process of financial markets, the development of the money market typically precedes the development of the capital market.

A capital market can be further classified into primary and secondary markets. The primary market is meant for new issues and the secondary market is one where outstanding issues are traded. In other words, the primary market creates long-term instruments for borrowings, whereas the secondary market provides liquidity through the marketability of these instruments. The secondary market is also known as the stock market.

Link Between the Primary and the Secondary Capital Market

- A buoyant secondary market is indispensable for the presence of a vibrant primary capital market.
- The secondary market provides a basis for the determination of prices of new issues.
- Depth of the secondary market depends on the primary market.
- Bunching of new issues affects prices in the secondary market

Primary Capital Market and Secondary Capital Market

Even though the secondary market is many times larger than the primary market, they are interdependent in many ways.

- The primary market is a market for new issues, but the volume, pricing, and timing of new issues are influenced by returns in the stock market. Returns in the stock market depend on macroeconomic factors. Favourable macroeconomic factors help firms earn higher returns, which, in turn, create favourable conditions for the secondary market. This in turn, influences the market price of the stock. Moreover, favourable macroeconomic factors necessitate raising fresh capital to finance new projects, expansion, and modernization of existing projects. A buoyant secondary market, in turn, induces investors to buy new issues if they think that is a good decision. Hence, a buoyant secondary market is indispensable for the presence of a vibrant primary capital market.
- The secondary market provides a basis for the determination of prices at which new issues can be offered in the primary market.
- The depth of the secondary capital market depends upon the activities in the primary market because the bigger the entry of corporate entities, the larger the number of instruments available for trading in the secondary market. The secondary market volume surge in 2007–08 was part driven by a rampant primary market, as newly listed stocks tend to have a high turnover.
- New issues of a large size and bunching of large issues may divert funds from the secondary market to the primary market, thereby affecting stock prices.

Characteristics of Financial Markets

- Financial markets are characterized by a large volume of transactions and the speed with which financial resources move from one market to another.
- There are various segments of financial markets such as stock markets, bond markets—primary and secondary segments, where savers themselves decide when and where they should invest money.
- There is scope for instant arbitrage among various markets and types of instruments.
- Financial markets are highly volatile and susceptible to panic and distress selling as the behaviour of a limited group of operators can get generalized.
- Markets are dominated by financial intermediaries who take investment decisions as well as risks on behalf of their depositors.
- Negative externalities are associated with financial markets. A failure in any one segment of these markets may affect other segments, including non-financial markets.
- Domestic financial markets are getting integrated with worldwide financial markets. The failure and vulnerability in a particular domestic market can have international 'ramifications.' Similarly, problems in external markets can affect the functioning of domestic markets.

In view of the above characteristics, financial markets need to be closely monitored and supervised.

Functions of Financial Markets

The cost of acquiring information and making transactions creates incentives for the emergence of financial markets and institutions. Different types and combinations of information and transaction costs motivate distinct financial contracts, instruments and institutions.

Financial markets perform various functions such as

- enabling economic units to exercise their time preference;
- separation, distribution, diversification, and reduction of risk;
- efficient payment mechanism;
- providing information about companies. This spurs investors to make inquiries themselves and keep track of the companies' activities with a view to trading in their stock efficiently;
- transmutation or transformation of financial claims to suit the preferences of both savers and borrowers;
- enhancing liquidity of financial claims through trading in securities; and
- providing portfolio management services.

A variety of services are provided by financial markets as they can alter the rate of economic growth by altering the quality of these services.

KEY TERMS

Bank-based Financial System	Financial Instruments	Informal Financial System
Capital Market	Financial Markets	Market-based Financial System
Financial Broadening	Financial Services	Money Market
Financial Deepening	Formal Financial System	Primary Market and Secondary Market
Financial Institutions	Free-rider	

SUMMARY

1. A financial system is a complex, well-integrated set of sub-systems of financial institutions, markets, instruments, and services which facilitates the transfer and allocation of funds, efficiently and effectively.
2. The financial systems of most developing countries are characterized by coexistence and co-operation between the formal and informal financial sectors.
3. Formal financial systems consist of four segments or components: financial institutions, financial markets, financial instruments, and financial services.
4. Financial institutions are intermediaries that mobilize savings and facilitate the allocation of funds in an efficient manner. Financial institutions can be classified into banking and non-banking, term finance, specialized, sectoral, investment, and state-level.
5. Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.
6. The main organized financial markets in India are the money market and the capital market. The first is a market for short-term securities while the second is a market for long-term securities, *i.e.*, securities having a maturity period of one year or more.
7. Financial markets are also classified as primary and secondary markets. While the primary market deals in new issues, the secondary market is meant for trading in outstanding or existing securities.
8. Financial services are those that help with borrowing and funding, lending and investing, buying and selling securities, making and enabling payments and settlements, and managing risk exposures in financial markets.

9. The RBI regulates the money market and the SEBI regulates the capital market.
10. The four sub-systems do not function in isolation. They are inter-dependent and interact continuously with each other. Their interaction leads to the development of a smoothly functioning financial system.
11. The functions of a financial system include mobilizing and allocating savings, monitoring corporate performance, providing payment and settlement systems, optimum allocation of risk-bearing and reduction, disseminating price-related information, offering portfolio adjustment facility, lowering the cost of transactions, and promoting the process of financial deepening and broadening.
12. The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) central bank, (v) a sound banking system (vi) an information system, and (vii) a well-functioning securities market.
13. The two types of financial system designs are: bank-based and market-based.
14. At one extreme is the bank-dominated system, such as in Germany, where a few large banks play a dominant role and the stock market is not that important. At the other extreme, is the market-dominated financial system, as in the US, where financial markets play an important role while the banking industry is much less concentrated.

REVIEW QUESTIONS

1. What is a financial system? Discuss the components of a formal financial system.
2. Discuss the types of financial markets and their inter-relationship.
3. What are the characteristics and functions of financial markets?
4. 'A market-based financial system is preferable over a bank-based system.' Comment critically.
5. 'A financial system is a well-integrated system whose parts interact with each other.' Explain.

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