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A STUDY OF FINANCIAL INSTITUTIONS AND ECONOMIC DEVELOPMENT

CANDIDATE NAME = RAJU S
DESIGNATION- RESEARCH SCHOLAR MONAD UNIVERSITY HAPUR U.P
GUIDE NAME = Dr. Anshuman Sharma
DESIGNATION- PROFESSOR MONAD UNIVERSITY HPUR U.P

ABSTRACT

The ability of efficient and established financial markets to boost economic growth by enhancing the allocation and usage of savings in the economy is widely known in economic research. External finance limitations that stifle business and industrial development are eased by better-functioning financial systems. There is a growing amount of empirical evidence, including firm-level studies, industry-level studies, individual nation studies, and cross-country comparisons, demonstrating this strong, positive relationship between financial system functioning and long-run economic growth. Banks, other financial and investment organisations, and non-banking financial firms make up the Indian financial system. These banks and non-banking financial institutions provide a diverse variety of products and services, all of which operate in well-developed capital and money markets. India has become one of the world's fastest growing economies as a result of several economic changes.

KEYWORDS: Financial Institutions, Economic Development, financial markets, financial and investment organisations

INTRODUCTION

In today's economy, finance is a crucial component of all economic activity. The availability of sufficient and timely financing is practically essential to economic development. Finance pulls together various parts of the confederation and integrates them into a cohesive whole, allowing the organization to operate efficiently toward accomplishing its objectives. Because of this, finance is the backbone of business. Goods and services are exchanged for income in the barter economy. Physical property, such as land, tools, or other commodities, may be used to generate income for the receiver. (b) via the provision of entrepreneurial services (c) through the use of labor. All three inputs must be provided in order for production to occur. Each cycle of resource supply generates output. After independence, however, resources, inputs, goods, and services may now be considered money in our economy.

In the economy, the financial sector may take on various forms. Legal arrangements, instruments, financial intermediaries, and markets are all included. Economic surpluses are mobilized and transferred to regions of financial deficit via a financial system. Any development plan relies heavily on it. As a result of offering a wider range of financial assets to the public, the financial system encourages saves. Household savings were pooled and allocated to various areas of the economy in order to boost output. It is essential that credit be distributed equitably and judiciously so that all sectors are equally justified in order for the economy to develop.

FUNCTION OF FINANCIAL INSTITUTION IN INDIA

The functions of Financial Institutions

have been tuned to the needs of industry, small scale industry, including traditional ones and agriculture. The principal functions are common to all financial institutions. These are –

1. **Payment Mechanism:-** Financial institution facilitates payments by enabling business government and consumers to complete transaction without cash. Checks and credit cards are used for the bulk purchase. Recently financial institution have developed many new payment services including money market, telephone bill-paying services, information-encoded credit and debit cards and electronic machines that accepts deposits and dispense cash.
2. **Promoting Investment:-** The Financial institution supplies credit to support purchases of goods and services and to pronounce capital investment such as construction of buildings, purchase of machinery and equipment. Investments increase the productivity of resources and make a healthy physical quality of lifepossible for individuals and families.
3. **Risk Diversification:-** Because of their immense size financial institution are able to bulk purchase of investments and reduce the negative effect of one investment returning much lower than expected rate. The negative effects of one asset in a small portfolio which many investor have, is diluted by holdings of hundreds of assets. Financial institutions pool, distribute, reduce and manage risk better through greater diversification of the portfolio which is not possible for any single, particularly small savers.
4. **Portfolio Management: -** Financial institution also acts as advisers and portfolio managers of most of the primary securities owned in India. Investments are protected from fraud borrowers by loan officer and well trained investment analyst who seek good investment opportunities and securities.
5. **Maturity Transformation:-** Financial institution offers savers the alternate forms of deposit in respect to their liquidity, risk return preference and lend borrowers the loans of long term maturities required by them. The financial institutions borrow less and lend more and in the process, they change the length of debt in such a way that it sooths the liquidity performance of the ultimate funds users. In so doing, they encourage the savers to pursue from unproductive investment to productive investments.
6. **Income Taxes: -** financial institution transfer tax deduction from one time period to another and from low to high income taxpayers. For example, income invested in and earned through pension funds is not taxable until retirement, when rates generally lower than before retirement. Also income taxes are not applied to some services provided by financial institutions. When services, are provided in lien of interest, payments, customers are said to receive implied interest. These benefits are a form of implicit interest and usually are exempt from income taxes, whereas explicit interest payments are generally subject to income tax.

FINANCIAL AND ECONOMIC DEVELOPMENT

"Development is an unpremeditated and discontinuous change of stationary state that forever alerts and displaces the equilibrium, state that previously exists;

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while growthis steady and gradual change in long run would come about by the gradual rise in the rate of savings and population."

- J.A. Schumpumpeter

The importance of financial institution in promoting economic development has been accepted. Financial institutions help the development process by influencing both the saving and investment. These financial institution acts as the bridge between the saving of the various sources to invest them and productive uses. The major source of savings in the country like India is from the household sector, but here one limitation is that these savings amount are so small individual wise, that it can hardly be invested by them directly to the industrial or the other sectors of economy.

Economic Development and financial System

The financial system act as an efficient conduct for allocating resources among competing users, The role and the importance of the system in process of the economic growth have evolved overtime along with the changing of paradigms.

The financial system provides the services which are essential in the modern economy. The use of stable and broadly accepted way of exchange decreases the cost of transactions. It facilitates trade and therefore, specialization in the production.

Financial assets with liquidity, attractive yield, and risk characteristics uplift saving in the financial form and by evaluating the alternative investment and keeping the eye on the activities of the borrowers, financial intermediaries raise the efficiency of resources use. Access to the variety of the financial instruments enables the economic agents to pool, exchange risk and price. Trade and the efficient use of the resources, saving money and risk takings are cornerstones of the burgeoning economy.

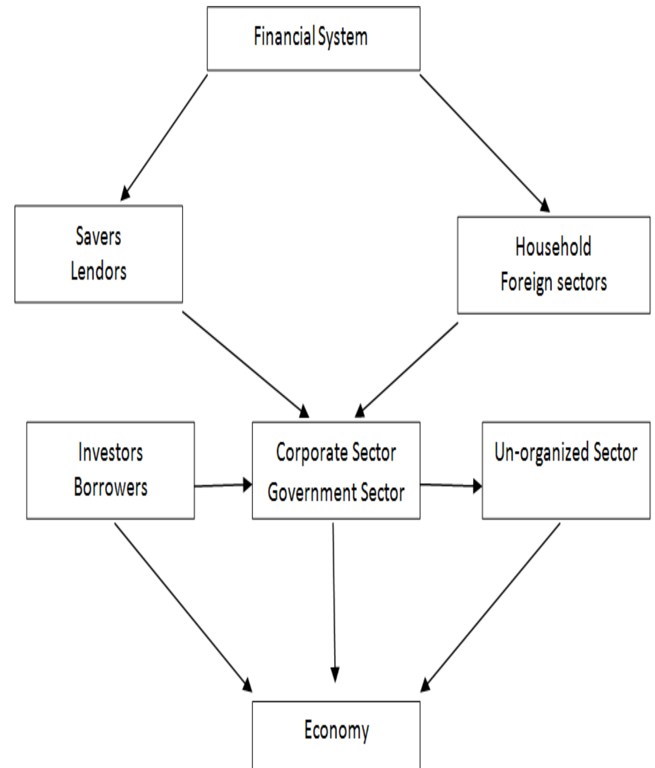

Figure 1Inter-relation between financial System and the economy

In the past government's efforts to promote economic development by controlling interest rates, directing credit to the priority sectors and securing funding that are inexpensive for their own actions have undermined the financial development. In recent years, the financial systems have come under further stress, as results of the economic shocks of the 1980's many borrowers were not able to service their loans. In more than 25 developing countries, government assists troubled intermediaries. The restructuring of insolvent intermediaries provides the governments with an opportunity to re-think and re-shape their financial system.

Conditions that support of the development of a more strong and equitable financial structure would raise the ability of the home financial system to contribute growth. By restoring the macroeconomic stability, in building better legal accounting, and regulatory system, specifying rules for the fuller disclosure of data and levying taxes that do not fall immoderately on finance, government can lay the foundations for functioning of the financial system smoothly.

The Indian financial system composed of an impressive network of banks other financial and the investment institutions offering broad range of products and services, which functions together in fairer development of capital and money markets. As such, financial system has to occupy a crucial role in the process of the economic development.

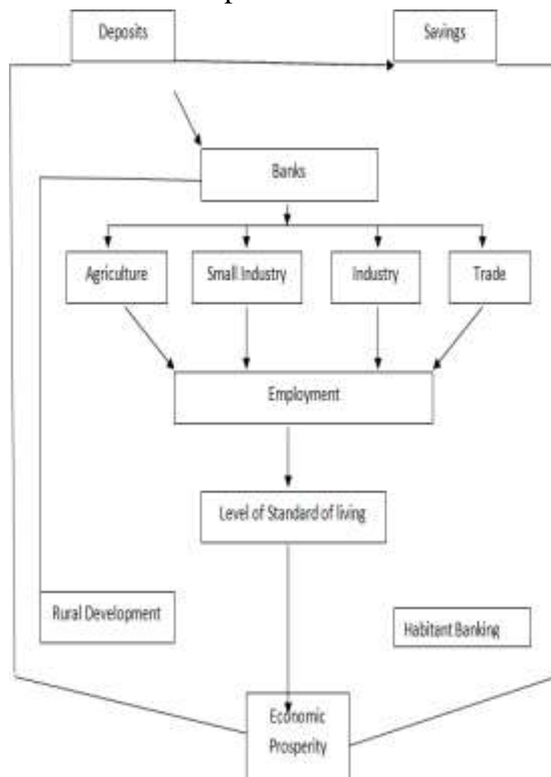

Figure 2 The role of Financial Institution

ROLE OF THE FINANCIAL INSTITUTIONS IN ECONOMIC DEVELOPMENT

The main distinguishing feature between developed and a developing country lies between its focus to strengthen and economic growth and uplift its economy in the right direction and rest all is, mystery. Developed countries do have a stronger economic growth as compared to developing countries. In developing countries the major factor which create hurdle in the economic rise are over population, illiteracy and political instability. Economic growth is dependent on the financial development of financial institutions and investment banks, commercial banks, bonds and stock exchange. Smooth and effective functioning of various activities in the society is dependent on the banking sector. Finance is the core of socio-economic growthtrajectory of the society.

During early independent period of India its main objective is to attain financial growth with social justice and equity, to strengthen the banking system of India. Banking system collects money from them who have spare money or those who are saving in their income and lending that money to them, who require. This system is highly valuable and necessary for any community to survive. But the role of commercial banks is not confined to lending money to the needy ones but to those also who are in a position to invest in an enterprise and create a profitable credit. This is a more complex task in view of dynamic changes in the economic uplift of a developing country. In this way the job of financial sector becomes very important in mobilization and allocation of financial saving from savers to borrowers. Structure

of banking sector in any developing country depends on its performance efficiency and ability to accumulate savings and channelize them into productive investment.

There are various opinions with regard to origin of the word 'bank' in the modern sense. According to few authors, the word 'bank' was derived from a French word 'bancus' or 'banque' that means a 'bench'. In the beginning, the bankers and the Jews of Italy, transacted their work on benches of market place. If banker failed, then his 'banque, (bench) was used to be broken in pieces by the public, which signifies the bankruptcy of an individual banker. Some authors say that the word 'bank' was originally obtained from German word 'Banck' which means a joint stock fund that was Italianized into 'banco' when the Germans were masters of Italy. 'Banco' means stack of money. The word' bank' is used in modern times, means an organization accepting money in the form of deposits that are used to be lend. In India, the Banking Regulation Act, 1949 defines bank as a banking company which transact for the purpose to lend or invest the deposits of money from the common public, and repaid on demand or withdrawal through cheque, draft, order etc.

In present day bankers have 3 ancestors: goldsmiths, money lenders and merchants. The goldsmiths used to accept money and other important, valuable items of their customers to keep it safe and issued receipts of them. These receipts were used as medium of exchange. The money lenders lent their surplus funds to the needy and earned income by way of taking high interest. The merchants were primarily traders and they had to oblige their customers by keeping their money in safe custody. Banking business was their side occupation. Today, we can see all the features of all three types of functions in modern banks.

During period of Queen Elizabeth, goldsmiths of England possessed position for modern bank. Self-employed persons, education, car and housing loans for weaker sections and consumption loans were also included. Various innovative schemes such as village adoption, agricultural development branches and equity funds for small units etc. were introduced for the potential disbursement of bank credit. For making the banking sector a crucial of the planning process in the country, credit planning was introduced. Banks prepared quarterly credit budgets to bring about more correlation between the demand for and supply of credit.

In post-independence era despite rapid rise in deposits and credit granting ,public sector banks suffered from low profitability over years, main reasons being deceasing interest income ,and increased operative cost of banks. They had relatively low rate of interest to earn and had to keep high proportion of deposits in RBI as CRR(cash reserve ratio) and SLR (Statutory Liquidity Requirements).moreover they had to loan money to weak sections of society at low concessional ate of interest of 4%only.public sector ban was also enforced by government to lend in agriculture and other important sectors, nearly all of them were dubious in nature regarding to pay their dues. Subsequently their loan become hard and doubtful to recover and was commonly known as non performing assets

Cost for operating bank was relatively costlier considering branch expansion, recruitments, various trade union activities, low productivity, heavy salary bill. All of these factors lead to reduced profitability of banks, with poor customer friendly atmosphere and outmoded work technology. These changes made them uncompetitive to face the challenges. This needed urgent and major changes in reforms so that public sector bank could come out of their weaknesses

Government of India set up a big level committee with Mr. Narsimham the former governor of Reserve Bank as chairman o bring reforms related to structure, organization, functions and financial system procedures. On these recommendations of Mr. Narsimhanm committee, first phase of financial sector improvement was to reform operational efficiency of banking sector were initiated in 1991 and second wasstarted in 1998.

The major reform measures are given below:

(i) Progressive reduction of Cash Reserve Ratio and Statutory Liquidity Ratio.
(ii) Phasing out concessional rate of interest to the priority sectors.
(iii) Deregulation of interest rates.
(iv) Introduction to prudential norms relating to capital adequacy, asset qualification, provisioning and income recognition
(v) Setting new private sector banks in a view to inducing greater competition and for improving operational efficiency of the banking system.
(vi) Permission to foreign banks to open offices in India either as branches or subsidiaries.
(vii) Setting of Lok Adalats, Debt Recovery Tribunals, ARC, Settlement Advisory Committee, Corporate Debt Reconstructing Mechanism etc. for quicker recovery / restructuring. Promulgation of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and its subsequent changes to ensure creditor part
(viii) Establishment of the Apex supervision as Board for Financial Supervision for non-banking financial companies, commercial banks and financial institutions
(ix) CAMELS an introduction of supervisory rating system, strengthening of off- site surveillance by control returns move towards supervision that are risk- based, consolidated financial conglomerates and its supervision.
(x) Recasting the statutory auditor’s role, increased internal control by strengthening internal audit.
(xi) Introduction of INFINET as a communication backbone to the financial sector, introduction of NDS (Negotiated Dealing System) for trading that is screen-based in Real Time Gross Settlement (RTGS) System and government securities etc.

Financial development is generally defined as the process that highlights the improvement in quantity, trust, quality, and efficiency in financial intermediary services. The process involves the communication of many activities, Institutions that are possibly associated with the economic growth. Financial

development has a crucial role in economy. There are 2 schools of thought focusing towards this study. First is expressionist while the other is structuralism. These include currency, term deposit, demand deposits, (each as portion of true GDP) and M2/real GDP.

DETERMINANTS OF FINANCIAL DEVELOPMENT

Financial Development is closely related with economic growth and economic growth within a country is indicator of development in the country. Economic growth is evaluated by various factors that also determine the financial progress. There are numerous factors which determine financial development. Few of them are below-

1) **Gross Domestic Product :-** Gross domestic product is the basic tool to evaluate overall economic output of a country and is usually correlated to physical quality and standard of living. it can be assessed by product approach ,income approach and expenditure approach. It is defined as market value with all fuel goods and services that are produced in a domestic economy during the course of one year and also the income earned by foreigners locally minus income earned abroad by nationals.
2) **Gross amount of money (M2)** :- M2 is the gross amount of money in the economy in a particular period of time; it represents money and its close allies. Economist uses M2 when he need to explain and quantify the sum of money in circulation there are various ways to define money, but primary measures usually include the currency in circulation along with the demand deposits. The Money supply information are recorded and also published generally by the governmentor else by central bank of that country. Public and private-sector analysts have monitored for long time changes in money supply as of its possible effects on price level, rate of inflation and overall business cycle.
3) **Savings :-** It is an important detrimental factor because when economy improves earning of people increases which increases saving of people in various forms like bank saving, pension plan, personal finance. Saving is the preservation of money. Saving may also include reducing of expenditures like recurring costs. In regards with personal finance, saving enumerate low-risk conservation of money, as in a saving deposit account in contrast to investment, where the risk is higher.
4) **Advances to deposits ratio :-** Advances and Deposits are the important terms of financial development. Advances refer to the amount lend by banks or other financial institutions to the business personnel or households whereas deposit isthe amount presented into banks by public. The economy is directly proportional to savings and incomes of people that also increase the deposits in banks. As the deposits rise in the banks, the advance given by the banks also starts to raise resulting money circulation in the economy (Paul &Vassili, 2001).
5) **Exports/ Imports**: - Export is any

commodity transported from one nation to another in a legal fashion typically for trade. Export goods are domestic producers and foreign consumers whereas import goods are foreign producers and domestic consumers. Import is any good or commodity brought in one nation from another nation in a legal fashion for trade. Import and export thus lead to formation of basis of international trade which means expansion of business and ultimately expansion of economic and financial development. For healthy financial development export market should always be greater than import market.

CONCLUSION

The role played by the financial institution in promoting the economic development of the country is very vital since inception. This can be judged by comparing the performance of different sectors before and after the establishment of these institutions. They have helped in improving the overall economic situation since the date of their inception. In the industrial sector, IDBI is an example which has assumed the responsibility of delivering the growth of different sector of the economy. It has provided financial assistance and other financial services to the various sectors of economy according to their requirements. It has diversified its activities and provided funds to various areas and people who needed such boost. Due to initiative taken by these institutions, the latest technology, machineries, equipment and technical know-how have been quite accessible by various sectors of economy. Our country has gained the advantages of industrialization only after the establishment of these institutions. Earlier, our economy has faced a huge financial crunch in this sector. In other words we can say that these financial institutions have always assumed the responsibility of diversifying the available resources of the economy to various areas and sectors, so that we can obtain a balanced economic development of each and every region.

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