CHAPTER III
A REVIEW OF THE FINANCIAL SYSTEM OF INDIA

"Historical experience shows that financial development in general proceeds from simple lending and borrowing arrangements to a system dominated by commercial banking and eventually to a broader system complemented by a variety of non-bank financial institutions and well-functioning money and capital markets."

- Yung Chul Park


An Overview

A financial system is defined as a sector engaged in the creation of different types of assets that creditors wish to hold, and financial liabilities that debtors are willing to incur. Thus, the variations in the size and composition of assets and liabilities of financial institutions and the type of financial services offered alter the portfolios of other sectors as well as the decisions on savings and investments. A financial sector is a complex of markets for financial assets and a source of financial institutions or intermediaries. Thus, a financial system in an economy comprises financial institutions to play the intermediary role, instruments that meet the diverse preferences and markets, which caters to the requirements of the lenders and borrowers. In a broader sense, Financial intermediaries or institutions are engaged in bringing together the ultimate provides and ultimate users of finance. They are distinct from brokers who, acting as intermediaries/ middlemen, enter into transactions as principals whereas financial intermediaries either themselves borrow or take up funds in order to unlend them. These intermediaries create claims on themselves matched by assets, which are largely claims on others acquired by
them. Thus, they provide various types of services and their major function is to mobilise savings and ensure efficient allocation of savings among various investment projects whereby the savers get attractive and assured returns. They also serve the needs of both lenders and borrowers and reconcile their divergent financial requirements. The financial institutions are also distinguished in terms of services provided by them. Banking institutions are unique as they provide payment facilities. Insurance institutions are also unique in one sense, as their services are contractual in nature. Term-lending institutions comprising of development banks and other institutions provide medium and long-term loans to various sectors of the economy. The non-bank financial intermediaries comprising a heterogeneous group of financial institutions, raise funds from the public either directly or indirectly, and lend to their members for a variety of purposes. Other financial institutions provide specialised services, such as housing loan, consumer loans etc. In this process, financial intermediaries issue a variety of financial instruments, which take the form of currency deposits, shares, bonds, debentures, loans etc. On the super structure of financial institutions, there exist the regulatory institutions. Financial instruments serve as a means of exchange and trading of these instruments takes place in the financial markets. Financial markets provide an effective payment mechanism and credit delivery system and thereby facilitate transmission of funds from one sector of the economy to another. Brokers help the economic agents to borrow or lend in the organised markets to function in an efficient manner. They provide information to participants so that the lenders and borrowers and savers and investors strike a fair bargain. They also perform the vital task of putting actual lenders and borrowers in
touch with each other. Thus, financial development connotes many qualitative changes viz., change in the nature and functioning of the financial intermediaries, introduction of new innovative instruments, and measures to develop the financial markets which may be necessary due to various factors, such as technology, change in the market preferences. With the emergence of new type of financial institutions or instruments or markets, the structure of the financial system undergoes a rapid transformation from a rudimentary to a modern one.

Consequently, the interrelationships between the financial sector and the real sector of the economy undergo a sea change, which has a significant impact on policy, reforms and measures. Safety, stability, efficiency and effectiveness of the financial system have been accorded high priority in the process of financial development. Park (1994) illustrates that financial systems and their evolutionary development have been a fundamental component of the overall development process in Japan, Korea and Taiwan. This has been possible due to real economic growth, change in the demand for various types of financial services, changes in institutional development within the financial system and changes in government policy concerning finance. The efficiency and effectiveness of finance is important in the understanding of the relationship between finance and economic development.

The prerequisites for a financial system include continuous availability of negotiable, transferable and high quality instruments for varying maturities that do
not involve high cost, adequate supply of suitable assets for any amounts, specialisation of functions among the constituents of the financial system, and besides, guaranteeing of liquidity through recourse to central bank credit. The participants include savers and investors, financial institutions such as, central bank, commercial and co-operative banks, development and other financial institutions, brokers, agents, regulators, credit rating agencies and others. The savers are the providers of resources and they reduce current consumption in order to consume in the future. The investors borrow for purchasing capital goods and for increasing the scale of business operations. The widening and deepening of the financial market by inducing competition among financial institutions have resulted in financial innovation and technological changes.

The financial sector forms an integral part of the macroeconomic system. In line with its macro economic policy objectives each country regulates the financial system. Financial reforms form an important segment of macroeconomic policies. The underlying objectives of the regulation of the financial system could be that they complement the objectives of monetary policy. They cater to the investor's interest since unlike physical products/tangible assets a financial product/asset does not have any physical manifestation with reference to its quality. The judging of its quality by claims attached to it would ensure reliability – i.e., ensure that firms entering the market are adequately capitalised and reliable.
Indian financial sector, ever since the beginning of the era of planning has significantly contributed to economic growth. During the successive decades of planning the financial sector has made significant strides in facilitating intermediation, proliferation of new instruments, emergence of new institutions and in integrating various financial markets in the country. Despite these developments in the financial sector, there have been a number of hurdles in the form of lack of liquidity, narrow investor base, lack of supportive infrastructural development such as technology, to support payment and delivery system, legal provisions, etc. The financial markets were fragmented due to administered structure of interest rates and the differential transaction costs and risk attached to various instruments was not evident. However, the financial development since the mid 'eighties focused on liberalization, deregulation and reforms. In recent years, integration of financial markets has become more important.

On the above background, this Chapter is organized as follows: Section I traces the evolution and history of the financial system in India; Section II is on the role of financial system in economic development; Section III is concerned with the economic contributions of the financial system; Section IV explains in detail the structure of the financial system. Section V covers structure of markets. Section VI reviews indicators of financial development and Section VII discusses the financial sector reforms introduced. Section VIII deals with regulatory framework. Lastly, Section IX presents a summary and concluding observations.
Section I: Evolution and History of the Financial System

The evolution of institutions and practices in the financial system is determined by the degree, character of economic development and the diversification of the economy. Park (1994) states that historically, financial development proceeds from simple lending and borrowing arrangements to a system dominated by commercial banking and sooner or later, moves towards a broader system complemented by a variety of non-bank financial institutions and well-functioning money and capital markets. He adds that, in most developing countries, largely because of problems of information uncertainty, open capital markets for primary securities such as stocks, bonds, mortgages and commercial bills are insignificant channels for mobilising and allocating savings. Therefore, for all practical reasons, the banking system that includes a variety of depository institutions dominate the financial system and is usually the only organised credit market available.

Historically, the evolution of financial system in India owes much to its locational advantage providing geopolitical and commercial avenues. Even during the colonial days, it served as an entrepot for regions and trade flourished. After India’s independence on August 15, 1947, various measures were undertaken to facilitate economic growth that also had considerable impact in the pattern of financial development. With the abolishing of the managing agency system, emphasis was placed on role of public financial institutions. With the spate of banking crisis in the ‘fifties, control over privately owned banks and other financial
institutions became important. One of the turning points in the history of financial
development was the nationalisation of Reserve Bank of India and establishment of
the Banking Regulation Act in 1949.

However, the true evolution of the financial sector was in the 'fifties with the
beginning of the era of planned economic development in India. As a first step, the
basic economic and social goals of the Central Government gained prominence with
the setting up of the constitution in 1950. Further, these goals were expressed in
the form of "Directive Principles of State Policy" which aimed to promote the welfare
of the people by securing and protecting, as effectively as it may, a social order in
which justice, social, economic and political, shall inform all the instructions of
national life. In pursuance of the objectives of socialistic pattern of society, the
Government of India in 1951 initiated a programme of planned economic
development based on the mixed economic system concept consisting of public and
private sectors complementing each other. The first Five Year Plan document
emphasized that as part of price policy, both financial and physical controls were
necessary. Price policy was considered as "partly a problem of allocation of
resources and partly a question of ensuring reasonable equality of sacrifice among
the different sections of people." It also recognised the importance of creation of the
financial infrastructure by the central bank in the economic development process.

The First Five Year Plan document (1950) stated that

"Central banking in a planned economy can hardly be confined to the
regulation of overall supply of credit or to a somewhat negative
regulation of the flow of bank credit. It would have to take on a direct and active role, firstly in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly ensuring that the finance available flows in the directions intended.

In 1954, the parliament declared "socialistic pattern of society" as the basic objective of economic policy wherein the “basic criterion for determining lines of advance must not be private profit, but social gain and that the pattern of development and the structure of socio-economic relatives should be so planned that they result not only in appreciable increase in national income and employment but also in greater equality in incomes and wealth. Major decisions regarding production, distribution, consumption and investment – and in fact all significant social economic relationships – must be made by agencies informed by Social Purpose” (Second Five Year Plan, 1956).

In the above background, this Section examines the evolution and history of the financial system as: (a) Emergence of Financial Institutions, (b) Emergence of Banks and (c) Emergence of Non-Banking financial Companies.

(a) The Emergence of Financial Institutions

The origin of development banks or term-lending institutions dates back as early as to 1822 when Societe Generale de Belgique was established in Belgium,
followed by 'Credit Mobiler' in 1852 in France. Consequently, Industrial Bank of Japan was set up in 1902 and it was followed by the emergence of a number of specialized industrial financing institutions in other European countries led to the establishment of many development banks by the end of the Second World War.

In India, the concept of 'development banking' came into being since the post World War II period. During the course of their emergence, these institutions differed widely in respect of their ownership, sources of finance, objectives, methods and scope of operations etc., depending upon the uniqueness of the need for finance. During the post Second World War period, the emphasis was placed on setting up finance corporations to provide term loans since most of the fixed assets of industries became depleted, crippled and obsolete. There was a dire need for replacing of equipment rehabilitation and modernisation. The Industrial Policy Statement (1945) explicitly stated the need to set up industrial investment corporations.

In the wake of absence of capital market institutions to mobilise savings and channelling them to productive uses, the need for specialised financial institutions was recognised as early as between 1906-13 by the Swadeshi Movement in India. The first and foremost expert group to examine the need and scope of setting up a separate financial agency was the Indian Industrial Commission in May 19, 1916 under the Chairmanship of Sir T.H. Holland. The Committee opined that the Indian banking system was inelastic and insufficient to cater to the long-term financial
requirements of the industry and recommended setting up of industrial banks. The External Capital Committee (1924) too while emphasizing the need of specialised banking system to mobilise idle resources observed, "India possesses a vast store of dormant capital awaiting development and in order to make this available for investment, banking facilities must be increased and extended." In July 1929, Government of India appointed the Central Banking Enquiry Committee to examine the need and scope of development banking in the country. The Committee recommended the establishment of a provincial corporation, with branches, if need be, to provide finance to industrial development and besides would act as an agency of the State aid to industries.

In the insurance sector, life insurance in its present form came into being with the establishment of the British firm, viz., Oriental Life Insurance Company in 1818 at Calcutta. The others followed, such as Bombay Life Assurance Company (1823), Madras Equitable Life Insurance Society (1829), Oriental Government Security Life Assurance Company (1874). During this period the Indian life was treated as sub-standard and an extra premium of 15 to 20 per cent was charged. The Indian Life Assurance Companies Act, 1912 was enacted to regulate life insurance business in India. Subsequent legislation aimed to collect statistical information from Indian and foreign insurers and protecting insuring public. The general insurance too came to India from the United Kingdom. Triton Insurance Company was the first to be established in India in 1850 at Calcutta. In 1907, the first Indian company set up in Bombay was called as the Indian Mercantile Insurance Company Limited. At the
time of Independence, the foreign insurers had a 40 per cent share in the total insurance business. Subsequently, their share declined.

After Independence, the absence of financial institutions to specifically cater to the term credit needs of the industry, besides to enable flotations of shares and debentures with a view to quicken the pace of industrialisation, led the Government of India to set up the Industrial finance Corporation under a separate Act in 1948 and its dealings were statutorily restricted to public limited companies and cooperative societies. Thus, the first ever oldest financial institution set up in the country was the Industrial Finance Corporation of India in July 1948 under the IFC Act, 1948 with the objective of providing medium and long-term credit to industry, especially, when normal banking accommodation was inappropriate or recourse to capital issue methods was impracticable. The entire share capital of Industrial Finance Corporation of India was initially subscribed by the Central Government, Reserve Bank of India, Scheduled banks and other financial institutions. With the establishment of Industrial Development Bank of India in 1964, the shares of Central Government and Reserve Bank of India were transferred to Industrial Development Bank of India and Industrial Finance Corporation of India's share capital was enhanced. The Industrial Finance Corporation of India's financial resources can be supplemented by borrowings from Government or market or through foreign currency loans. Industrial Finance Corporation of India has diversified its activities by setting up several subsidiaries. These include, Industrial Finance Corporation of India Custodial Services and Industrial Finance Corporation of India Investor
S~MWS Ltd., which was merged with Industrial Finance Corporation of India
Financial Services Ltd. since October 1, 1998, Investment Information and Credit
Rating agency (ICRA) for credit rating services, Risk Capital and Technology
Finance Corporation Ltd., which manages venture capital funds in some select
industries and its name has been changed to Industrial Finance Corporation of India
Venture Capital Funds Ltd.

Prior to early 'fifties several institutional developments took place and the
tempo continued in the next coming decades. As early as 1949, the Government of
Madras had mooted a proposal for a provincial institution to purvey industrial finance
in the state and the Madras Industrial Investment Corporation Ltd. was set up in
March 1949. Prior to this, in 1946 the Government of Punjab planned to set up a
corporation under the company's Act. Subsequently in 1949, the Government of
Bombay too decided to set up an Industrial Credit Corporation to supplement the
work of the Industrial Finance Corporation. The Government of Punjab urged the
Central Government to govern these corporations by a separate statute as the
functions would be distinct from those registered under the Companies Act. Thus,
in order to cater to the financial needs of small-scale units at the state-level, State
Financial Corporations was set up under the State Financial Corporation Act in
1951. They operate as regional development banks and perform an important
function of developing small and medium enterprises in their respective states in
keeping with national priorities. There are 18 State Financial Corporation in the
country, of which 17 were set up under the State Financial Corporation Act 1951.
The Tamil Nadu Industrial Investment Corporation Ltd. established in 1949 under the Companies Act as Madras Industrial Investment Corporation also functions as SFC. The National Industrial Development Corporation was set up in October 1954 by the Government of India to set up new industries to provide consultancy services and to finance rehabilitation and modernization of certain industries. In 1955 the Government also established the National Small Industries Corporation (NSIC). The Industrial Credit and Investment Corporation of India (now known as Industrial Credit and Investment Corporation Limited) was established on January 5, 1955 by the Government of India, World Bank and representatives of private Industry as a public limited company under the Companies Act, with the main objective of financing industrial projects by way of foreign currency loans and equity participation, to promote industries in the private sector and assist industrial development and investment in India. During the last several decades, Industrial Credit and Investment Corporation Limited has diversified into various fields which include, project finance, corporate finance, cash flow-based financing products, lease financing, equity financing, hybrid financing structures, syndication services, treasury-based financial solutions, risk management tools as well as advisory services. Besides, through its subsidiaries entered into new areas of business, viz., commercial banking, investment banking, non-banking finance, investor servicing, broking, venture capital financing and state-level infrastructure financing.

The Swadeshi movement stimulated the development of Indian Insurance companies. During the period 1912-38 there was a growth of mushroom companies.
Prior to 1912, they were regulated by the Indian Companies Act as this Act was not sufficient to control them, the Indian Insurance Act, 1912 was passed with the objective of regulating insurance business. Despite this, unhealthy practice of paying high commission under the managing agency system flourished up to 1938 and all insurance companies were in the private sector. Therefore, the Insurance Act, 1938 was passed. The major provision of the Act was that insurance should not be available on credit. All the life insurance companies were nationalized in 1956. Life Insurance Corporation of India has over the years introduced a variety of schemes and has made a remarkable progress in extending social security to weaker sections of the society through its Group Insurance Schemes. It is important to note that in terms of Section 27 (A) of the Insurance Act, 1938, Life Insurance Corporation should invest its funds as follows:

i) Central Government marketable securities being not less than 20 per cent,

ii) Loans to National Housing Bank including (a) above being not less than 25 per cent,

iii) State Government Securities including government guaranteed marketable securities, inclusive of (b) above being not less than 50 per cent, and

iv) Socially oriented sectors including public sector, co-operative sector house building by policy holders, own your home schemes, inclusive of (c) above not less than 75 per cent.
A reinsurance company, viz., India Reinsurance Corporation Limited was established in 1956 wherein all the companies voluntarily donated 10 per cent of their gross direct business. In 1957, a code of conduct was framed by the General Insurance Council to ensure fair and sound business practices in the general insurance industry. With an amendment in the Insurance Act in 1961, voluntary activities were streamlined with the notification of the Indian Guarantee and General Insurance Company Limited and India Reinsurance Corporation as "Indian Reinsurers". This also led to a pooling arrangement wherein some percentage of business was given to the Fire, Marine and Hull Insurance pool. In 1968, further amendments enabled social control over general insurance business. A Tariff Advisory Committee (TAC) was also set up to regulate investment of assets.

The second five-year plan envisaged setting up of industrial estates by State Governments through special corporations/or agencies. State Industrial Development Corporations were established under the Companies Act, 1956. It acts as catalyst for promotion and development of medium and large scale industries in their respective states. The functions of State Industrial Development Corporations include assistance and financing of promotion/establishment and execution of middle/large sized industrial undertakings of projects. Their scope is wider to accelerate the industrial development in the States by directly promoting various projects. In pursuance of the recommendations of the Working Group and Small Scale Industries Board, Small Scale Industrial Corporations were set up which was concerned with management of the industrial estates, provision of marketing
services and other infrastructural facilities. Their broad functions are to counsel finance, protect and promote interest of Small Scale Industries and provide them with capital, credit and technical/managerial assistance. A Working Group on State financial corporations was set up by Reserve Bank of India in June 1962 under the Chairmanship of Shri K.C Mittra to examine aspects relating to State Financial Corporation's policies, procedures, role in financing industries, legal and financial etc. and to suggest measures to improve the usefulness of the corporations. The Mittra Committee Report (1964), among many things, recommended that the institutions providing term finance to industry should be coordinated to avoid overlapping of operations. While National Small Industries Corporation should concentrate in promotional activities, State Financial Corporations should take up machinery line purchase business. The Small Scale Industrial Corporations should concentrate in providing marketing facility and State Industrial Development Corporation's operations need to be restricted to promotional functions, viz., formulating, executing and running of industrial projects. It also recommended that proliferation of institutions with similar functions and jurisdictions may be avoided. Thus, the important segments of the financial system came under the Central Government in the 'fifties.

In the 'sixties, the Industrial Development Bank of India came into being as a wholly-owned subsidiary of Reserve Bank of India on July 1, 1964 under an Act of Parliament. Its ownership was subsequently transferred to the Government of India in February 1976. With the amendment of the Industrial Development Bank of India
Act in 1995 so as to provide it with greater operational flexibility, Government reduced its holding to around 72 per cent by offering shares of Industrial Development Bank of India to the public for the first time. Industrial Development Bank of India caters to the growing and diverse needs of medium and large scale industries with the main objective of providing financial assistance and coordinating the working of institutions engaged in financing, promoting and developing industries. In the same year (1964) Unit Trust of India was formed under an Act of Parliament. It mobilises savings of small investors through sale of units and transforms them into corporate investments. To cater to the diverse needs of various segments of investor population, Unit Trust of India has introduced a number of schemes over the years. Since amendment to its Act in 1986, Unit Trust of India has started extending assistance to the corporate sector by way of loans and underwriting/direct subscription to shares/debentures.

In the ‘seventies, the general insurance companies were nationalized (1973). The General Insurance Corporation of India and its four subsidiaries, viz., National Insurance Co. Ltd., The New India Assurance Corporation Co. Ltd., The Oriental Insurance Co. Ltd., and United India Insurance Co. Ltd., cater to the various needs of the different segments of the economy through a number of schemes. They also are involved in financing industrial projects through term-loans, short-term loans and direct subscription to shares/debentures of new and existing industrial entities. The investment policy of General Insurance Corporation of India and subsidiary Companies is governed by Insurance Act, 1938, guidelines issued by Government.
of India from time to time and prudential norms approved by the Board of the Corporation. Under Section 27(B) of the Insurance Act, 1938, General Insurance Corporation of India and its subsidiaries should invest as follows:

i) Central Government Securities, being not less than 20 per cent;

ii) State Government Securities and other government guaranteed Securities, including (i) above, being not less than 30 per cent.

At present they channel over 90 per cent of their investible funds to socially-oriented sectors. They also grant loans to state governments, Housing and Urban Development Corporation (HUDCO) and Delhi Development Authority for construction of houses. Besides, they have set up a housing finance company in 1990 to provide long-term loan for the purpose to individuals.

On account of certain bank failures and to restore confidence of the depositing public in the banking system, the Deposit Insurance Corporation was set up in 1962. In 1971, the Reserve Bank established the Credit Guarantee Corporation of India Limited, as a public limited company with a view to integrating the twin and cognate functions of providing protection to small bank depositors and guarantee cover to credit facilities extended to small borrowers in the weaker sections of society. Since July 15, 1978, the two institutions were merged and came to be known as Deposit Insurance and credit Guarantee Corporation of India (DICGC).
In the ‘eighties, apart from specialised financial institutions in the industrial sector, financial institutions were also set up in the agriculture and rural sector, export-import, and the housing sector. The Agriculture Refinance Development Corporation (ARDC) was set up in 1969 and its functions were incorporated in the activities of the National Bank for Agriculture and Rural Development was set up on July 12, 1982 under an Act of Parliament as an apex development bank for promotion of agriculture, small-scale industries, cottage and village industries, handicrafts and other activities in rural areas. Its functions are credit related, promotional, developmental and regulatory. In the export sector, Export-Import Bank of India established in January 1982 by the Government of India, acts as the principal financial institution for financing, facilitating and promoting India’s foreign trade. Earlier, the Export Risk Insurance Corporation was converted into export Credit Guarantee Corporation of India. This was reconstituted as the Export-Import Bank of India. The Industrial Investment Bank of India (IIBI) (formerly the Industrial Reconstruction Bank of India), which is wholly owned by the Government of India was set up in 1985 under the Reserve Bank of India Act, 1984, as the principal credit and reconstruction agency for aiding rehabilitation of sick and closed industrial units. However, in March 1997, it was converted from a statutory body into a public limited company and since then it has been acting as a full-fledged all-purpose development financial institution.

With the growth in the capital market, there was a need for infrastructure facilities for servicing investors. The Stock Holding Corporation of India Limited
(SHCIL) was established as a depository institution by seven all India financial institutions in 1986. The main objective was to introduce a book entry system for the transfer of shares and other types of scrips to avoid voluminous paper work and reducing delays in transfers. It commenced its operations in August 1988 and at present it also provides custodial services.

The Industrial Finance Corporation of India had earlier set up a Risk Capital Foundation in 1975 as a society under Societies Registration Act, 1960 to provide supplementary finance on soft terms to first generation entrepreneurs. This was reconstituted under Companies Act, 1956 as Risk Capital and Technology Finance Corporation Ltd. It continues to support projects set-up by first generation entrepreneurs involving relatively innovative technologies, products and services through technology finance and venture capital schemes. Risk Capital and Technology Finance Corporation provides assistance in the form of conventional loans or interest-free conditional loans on a profit and risk-sharing basis with the project promoters and subscriptions to equity of projects with suitable buy-back arrangements with the promoters.

The Shipping Credit and Investment Company of India Ltd., (SCICI) was incorporated in 1986 as a public limited company to encourage and assist development and investment in shipping, fishing and related areas. It was merged with Industrial Credit and Investment Corporation during 1995-96.
With the objective of providing venture capital finance, Industrial Credit and Investment Corporation and Unit Trust of India set up a Technology Development and Investment Corporation of India (TDICI) in July 1988. It was reconstituted as Industrial Credit and Investment Corporation Venture Funds Management Company Ltd. It provides assistance to small and medium industries through project loans, direct subscriptions to equity and quasi equity instrument and other services.

In pursuance to the recommendations of the Working Group on Money Market (Vagul Committee, 1987), the Reserve Bank set up jointly with public sector banks and all India financial institutions, the Discount and Finance House of India (DFHI) April 1988 with the objective of developing the money market and to deal in money market instruments so as to provide liquidity in the market.

In the housing sector, there was a need to set up an apex institution. The National Housing Bank was set up on July 9, 1988 under the National Housing Bank Act as the principal agency to promote housing finance institutions and to provide financial and other support to such institutions.

The Tourism Finance Corporation of India Ltd. (TFCI), was promoted by Industrial Finance Corporation of India along with all-India financial institutions and leading commercial banks, as a public limited company under the Companies Act 1956. It became operational on February 1, 1989 as a specialised all-India development financing institution to provide financial assistance to the tourism
industry. It provides assistance in the form of rupee loans, underwriting/direct subscription to shares/debentures, guarantees for deferred payments, equipment leasing/equipment credit for setting up and/or development of tourism-related activities, facilities and services, which, inter-alia, include hotels, restaurants, holiday resorts, amusement parks and complexes for entertainment, education and sports, safari parks, ropeways, cultural centres, convention halls, all forms of transport industry, air taxis, travel and tour operating agencies, tourism emporia, sport facilities, etc. It also plays an advisory role for coordinating and formulating guidelines and policies related to financing of such projects.

The 'nineties saw the emergence of newer types of institutions to suit the needs of the changing financial system. Apart from specialised financial institutions in the housing and industrial sector, financial institutions also set up several subsidiaries in the areas of mutual funds, venture capital, factoring and other financial and portfolio services.

The Small Industrial Development Bank of India was set up in 1990 as a wholly-owned subsidiary of Industrial Development Bank of India. It serves as a principal financial institution for promotion, financing and development of industry in the small, tiny and cottage sectors.

Another important event that took place was the constitution of the Securities Exchange Board of India (SEBI) by the Government of India on April 12, 1988 as a
regulatory institution, with the objective of promoting orderly and healthy growth of the securities market to provide investor’s protection.

In order to develop an efficient institutional infrastructure for an active secondary market in government securities, the Securities Trading Corporation of India Limited (STCI) was set up in May 1994.

Another major development was the setting up of the Infrastructure Development Finance Company in January 1997, under the Companies Act, 1956 in order to provide impetus to the infrastructure sector. It has been constituted as an institution to facilitate the flow of private finance to commercially viable infrastructure projects and help mitigate commercial and structural risks contained therein, by designing innovative products and processes. It was incorporated with an initial paid-up capital of Rs.1000 crore by way of contributions from the Government of India, Reserve Bank of India, domestic financial institutions like Industrial Development Bank of India, Industrial Credit and Investment Corporation, Housing Development Financial Corporation, State Bank of India, Industrial Finance Corporation of India and Unit Trust of India and foreign financial institutions like Asian Development bank, International Finance Corporation, Standard Life Assurance Company, UK, and American International Group Inc., among others. In addition to equity, the Government of India and the Reserve Bank also provided subordinated loan of Rs.650 crore to Infrastructure Development Finance Company for a period of 15 years and it commenced its operations from June 1997.
(b) Emergence of Banks

The banking system is the oldest of the financial system with a long history. The principle of limited liability for banks came to be accepted under Indian Law since 1860. The present era of banking in India commenced with the establishment of Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) which were called as the "Presidency Banks" as they were given the powers to issue notes. However, these powers were withdrawn in 1862 as their notes did not become popular. During this period there was a mushroom growth of banks with the emergence of joint stock banks with limited liability. The Presidency Banks Act, 1876 permitted state partnered banks. The three Presidency banks were later reconstituted as the Imperial Bank in 1921 and was rechristened as the State Bank of India in 1955. Several banks came into being like Allahabad Bank Limited (1865), Punjab National Bank Limited (1895), Bank of India Limited and Canara Bank Limited (1906), Indian Bank Limited (1907), Bank of Baroda Limited (1908), Central Bank of India Limited (1911), Union Bank of India Limited (1919), Andhra Bank Limited (1923), Syndicate Bank Limited (1925), Bank of Maharashtra Limited (1935), Indian Overseas Bank Limited (1936), Dena Bank Limited (1938), United Commercial Bank Limited (1943) and United Bank of India Limited (1950). The First World War resulted in unsound banking practices and there was a series of banking crises during the period between 1913 and 1938 resulting in bank failures, which numbered between 1951 to 1988.
The Reserve Bank of India was established on April 1, 1934 as a shareholder's bank in five areas, viz., Bombay, Calcutta, Madras, Delhi and Rangoon (office closed in 1947) in order to secure an even distribution of shares all over the country. Its objective was "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." Scheduled banks came into being with the enactment of the Reserve Bank of India Act, 1935. In order to have close integration with the policies of the Bank and those of the Government, the Reserve Bank of India was nationalized on January 1, 1949. The Reserve Bank of India was given the powers to regulate, supervise and develop the banking system through the Banking Regulation Act, 1949. After the Second World War, there was a phenomenal growth of banking in terms of branches as well as funds due to the stimulus of monetary expansion and due to the war. Due to partition, there was another banking failure during the period 1947 to 1952.

The Second Five Year Plan initiated steps to create the necessary financial infrastructure by nationalising the Imperial Bank of India in 1955, which came to be known as the State Bank of India. This was done with the primary objective of extending "Banking facilities on a large scale, more particularly in the rural and semi-urban areas and for diverse other public purposes" (Preamble of State Bank of India Act, 1955). Today the State Bank of India is the largest bank in the country. The State Bank of India (subsidiary banks) Act was passed in 1959 by which 8 associate...
banks were created. The State Bank of Bikaner and State Bank of Jaipur were amalgamated in 1963 thereby lowering their number to 7.

In 1967, "social control" of banks was introduced by the Government of India with the objective of bringing some important changes in the bank management and credit policy. As this measure was inadequate, the Government on July 19, 1969 nationalised the major 14 Indian banks so as "to serve better the needs of development of the economy, in conformity with National Priorities and Objectives." The main objectives of nationalisation of banks were, (i) to re-orient credit flows to the neglected sectors, such as agriculture, small-scale and small borrower, (ii) increase branches particularly in the rural and semi-urban areas, and (iii) to mobilise savings through bank deposits. Further, on April 15, 1980 the Government nationalized 6 additional scheduled commercial banks each with demand and time liabilities exceeding Rs.200 crore. Of these 20 nationalised banks, the New Bank of India was merged with the Punjab National Bank in 1993 thereby taking the total to 19.

The cooperative banks came into being due to the passing of the acts of 1904 and 1912 by the central government, which were based on the principles of cooperative organisation and management. The Act of 1912 encouraged (i) federation of primary societies into central banks or banking unions for the purposes of supervision and finance, (ii) the growth of non-credit societies. With the rapid increase in the cooperative societies, Government appointed a Committee under the Chairmanship of Edward McLagan in 1915. It created an awareness of the
importance of audit and supervision. Under the Reforms Act, 1919, cooperation became the subject of provincial government. They were classified into agricultural and non-agricultural credit cooperative societies. Of the total number of credit societies, agricultural societies constituted 90 per cent. Among the non-agricultural credit cooperative societies, urban banks occupy a predominant place. The important role played by these banks was recognised by the Mclagan Committee on Cooperation in 1915, which observed, "Urban credit societies might serve a useful purpose in training the upper and middle to understand ordinary banking principles". The cooperative banks played an important role in dispensing agricultural credit and operate within specified regions with a federal set up. Till 1969 they substituted the informal sector lenders. Their share in institutional lending was high at 80 per cent till 1969. Later, they played a complementary role to the scheduled commercial banks.

In 1967, 'Social Control of banks' was introduced by Government of India with the aim of bringing in some drastic changes in the management and credit policy of commercial banks. As this measure proved to be inadequate, the Government in July 19, 1969 nationalised 14 major Indian banks, each with an aggregate deposit of Rs.50 crore or more, in order to "serve better the needs of development of the economy, in conformity with National Priorities and Objectives." In April 15, 1980, 6 more banks were nationalized each with demand and time liabilities exceeding Rs.200 crore. Of these 20 nationalised banks, the New bank of India was merged with the Punjab National Bank in 1993 thereby totaling 19 nationalised banks.
The Regional Rural Banks were established under the Regional Rural Banks (RRBs) Act, 1976 to cater to the needs of the rural sector. At present there are 196 Regional Rural Banks. In addition, there are primary (urban) Cooperative banks in the cooperative sector which operate in urban areas catering to small borrowers. Earlier they came under ‘non-agricultural credit societies’ located mostly in towns and cities catering to credit requirements of urban clients. These banks are organised on a limited liability basis. They are registered under the law relating to cooperative societies prevailing in a State where it is established. Its organisation and functioning are governed by the Cooperative Societies Act applicable to a particular State. The main functions of urban banks include promotion of thrift by mobilising deposits from members and non-members and to advance loans to members.

(c) Emergence of Non-Banking companies

The Non-Banking Financial Companies comprise a heterogeneous group of financial intermediaries, which raise funds from the public either directly or indirectly and lend them to their members. They are broadly classified into financial companies and non-financial companies. Financial Companies comprises of - (i) loan companies, (ii) investment companies, (iii) hire companies, (iv) leasing companies, (v) mutual benefit companies, (vi) miscellaneous finance companies and the (vii) housing finance companies. Non-finance companies are classified into Miscellaneous Non-Banking companies and Residuary Non-Banking Companies.
Since the 'fifties to the 'eighties the role of non-banking financial intermediaries was very insignificant in the financial system. The non-banking financial intermediaries in India have significantly grown both in terms of their size and scope of operations. This has been partly as a result of deregulation, liberalisation, innovation and diversification of the financial system. They form an integral part of the financial system calling for rationalisation and reforms in this sector. The emergence of their growth stems from the need to provide finance to activities, which were not provided by the banking system.

During the 'fifties with the launching of the five year plans in India, the non-banking financial intermediaries expanded their operations by accepting large volume of deposits by offering competitive interest rates. Moreover, due to tight monetary conditions restrictions were placed on credit besides the imposition of selective credit control measures and the non-banking financial intermediaries took advantage of the situation by mobilising deposits from the public to meet their working capital requirements, in the absence of regulation over deposit acceptance by these institutions.

During the 'sixties the non-banking intermediaries including non-financial and financial intermediaries increased their deposit holdings sharply and therefore, as an adjunct of monetary and credit policy, a scheme of regulating their deposits was formulated in order to protect the investors funds. Effective February 1, 1964, with the amendment of the Reserve Bank of India Act, 1934, a new Chapter III B was
inserted which empowered the Reserve Bank to regulate the acceptance of deposits by non-banking institutions. Under Sections 45J, 45K and 45L, 45N, 45MA of the Act, the Reserve Bank of India has been empowered to regulate or prohibit the issue of prospectus or through advertisements by these institutions regarding acceptance of public deposits; provide directions with regard to receipts of deposits, interest rate payable on such deposits and the period on which deposits may be received; and also prohibit deposit acceptance if these failed to comply with the directions.

Under Section 45N, the Bank has been empowered to inspect, as and when required, their books and accounts for the purpose of verifying the correctness or completeness of any statement, information or particulars furnished by them. In 1974, with further amendments, a new Section 45MA was introduced wherein it has become obligatory on the part of auditors to ascertain whether these institutions have furnished information on deposits received to the Bank.

In view of the growing importance of the non-banking financial intermediaries, the Narasimhan Committee recognised the need to integrate them with the mainstream of the financial system through issue of prudential guidelines and a comprehensive system of supervision. Accordingly, a Working Group under the chairmanship of Dr. A.C. Shah was constituted in May 1992 and the Reserve Bank of India accepted in principle the Working Group's recommendations. As per the recommendations, it was stipulated that all non-banking financial intermediaries with
Net owned funds of Rs.50 lakh and above are required to register with the Reserve Bank of India. Furthermore, it was stipulated that the non-banking financial intermediaries should subject themselves to the prudential norms prescribed for banks and financial institutions which relate to income recognition, accounting standards for investment, asset classification provisioning for bad and doubtful debts, capital adequacy and concentration of credit and investment. Since 1998, the non-banking financial intermediaries are also required to comply with all prudential norms prescribed by the Reserve Bank.

Section II: The Role of the Financial System in Economic Development

The financial system plays a vital role in the economic growth process. The level and growth of savings, investments and capital formation in an economy are important for their economic growth. The financial system, apart from serving as an effective payment system, plays a crucial role in transferring funds from one sector to another. In this process, the financial system allocates resources in the economy quickly and efficiently and accelerates economic development.

It is important that the financial system is efficient. Tobin (1984) distinguishes between various types of financial efficiency and views that only insiders can make money in an efficient market since the market already discounts what others know. He terms this as ‘Information-arbitrage efficiency’. By ‘fundamental-Valuation efficiency’, he means the valuation of a financial asset that accurately reflects future
payments. For defining ‘Full-Insurance efficiency’, he uses the Arrow–Hebrew contracts which are for specified goods in specified ‘states of nature’. According to Tobin, financial markets are efficient if they enable economic agents to issue for themselves deliveries of goods and services in all future contingencies either by surrendering some of their own resources now or by contracting to deliver them in a specified future contingencies. The fourth termed as ‘functional efficiency’ is derived from the economic function of the financial industry. These include, pooling of risks and allocating it to those who are able to bear them, facilitating transactions and providing mechanisms and payment networks, mobilization of savings for investment in physical and human capital, domestic and foreign, private and public, and allocating saving to their socially productive uses.

The functions of the financial system are manifold. Therefore, it is necessary that the financial system functions,

* At a high level of operational and allocative efficiency.
* Is highly stable and
* Introduces several innovative instruments and financing techniques to meet the changing preferences of the participants.

From the above, it follows that as the economic activities depend on the financial system which provides short and long-term credit facilities on time. Besides, the smooth running of the financial system enhances levels of saving and investment and provides incentives for the allocation of scarce resources to those
uses, which give highest returns. It ensures smooth flow of financial resources from
the savers through institutions and markets to Investors. Thus, it facilitates effective
capital accumulation. Another important function of the financial system is to provide
an efficient payment system for all the segments of the economy, such as, Government, central bank and the commercial banks. It also serves as a tool for
the central bank to signal its various policy stance. Moreover, the quality of services
provided by the financial system is important as it affects the performance of the
economy. The role of the financial system in the economic development depends
upon the extent to which it can widen its reach to a large population. It minimises the
transaction costs and the extent to which it can provide speedy and effective
response. The financial system thus improves the allocational efficiency in the
economy and thereby improves capital formation as well as productivity of the
capital. Productivity of capital and cost of resources or interest rates are important
indicators of the strengths of the financial system and the economy. The efficacy of
any financial intermediary depends upon the extent of customisation of products to
suit the various requirements of the investors and the savers.

Lastly, the financial system provides timely credit or finance. Economists
such as Schumpeter, Keynes and Kalecki have pointed out that investment financed
through credit generates the equilibrium level of income wherein the ex post savings
are equal to ex ante investments. The First Five Year Plan document also
emphasized this and states that, “judicious credit creation somewhat in anticipation
of the increase in production and availability of genuine savings has also a part to
play, for, it is conceivable that without this kind of initial push the upward pressure may not start at all or may fail to gather momentum."

Section III: The Economic Contribution of the Financial System

The economic contribution of the financial sector to the Gross Domestic Product, measured in terms of banking, insurance, real estate, ownership dwellings and business services grew at an average compound growth rate of 4.9 per cent per annum in real terms during 1951 to 1997. The Gross Domestic Product at current market prices grew at an average compound growth rate of 11.6 per cent per annum, while the total assets of financial institutions including Reserve Bank of India grew at the rate of 14.0 per cent per annum. The per capita assets grew at 11.6 per cent as compared with per capita Gross Domestic Product growth of 9.3 per cent per annum.

Although, the financial sector is not a major employer, it nevertheless has significantly contributed to the total employment growth in the organised sector. The contribution towards employment generation by finance, insurance, real estate etc., was at an average compound growth rate of 4.8 per cent per annum during the period 1951 to 1997 as compared with 4.3 per cent in the total employment generated in the public and private sectors. The share of finance, insurance, real estate etc., in the total employment increased from 4.6 per cent in 1951 to 5.7 per cent in 1997. Employment in the financial sector has been accompanied by
development of workers skill and labour productivity as reflected in the increased proportion of tertiary sector in the Gross Domestic Product from 29 per cent to 43 per cent during the same period. Besides, technological advancements, computerisation and automation have increased the value added per worker. The development of the financial sector has created a spillover effect in other sectors particularly since the mid 'eighties and it has gathered momentum in the 'nineties. It has also created a demand for new regulatory and other institutions.

The economic contribution of the financial system can also be gauged by several factors such as contribution of the savers in the gross domestic savings and its composition, and Gross Domestic capital formation. The sectoral contribution of the total savers in the country is presented in Table III.1. It reveals the predominance of household savings as a ratio to Gross Domestic Savings although it showed a marginal decline while there is a steady decline in the Government savings particularly since the mid 'eighties. The private corporate saving shows a steady increase during the same period. Besides, since the 'nineties, household savings contribute almost one fifth to Gross Domestic Product.

The composition of household savings is presented in Table III.2. In the 'fifties and up to 'seventies, the physical savings as a proportion of total savings of the household sector showed fluctuations and continued to be higher. Thereafter, it showed steady decline to reach 47.4 per cent in 1997. Financial savings as a proportion to total savings was only 8.6 per cent after reaching 41.5 per cent.
declined to 28.1 per cent and thereafter showed a steady increase to reach a peak of 52.6 per cent. In terms of the share in Gross Domestic Product, the physical savings although fluctuated, increased steadily since the 'seventies. The share of financial savings increased at a slower pace to reach 10.7 per cent, which is one half of that of the former. It is evident that there is a shift in favour of financial savings particularly since the mid 'eighties.

The composition of household saving in the form of financial assets is given in Table III.3. It may be seen from the table that the households preferred to hold a higher proportion of currency till the mid 'sixties and slowly bank deposits, other forms of savings gained prominence. It shows that households preferred to hold a major proportion of their financial assets in the form of bank deposits (33 per cent), followed by non-bank institutions (17 per cent), provident funds (17 per cent) and insurance funds (10 per cent) in 1997.

The sectoral contribution of capital formation is given in Table III.4. It is evident from the Table that the share of public sector in gross domestic capital formation in 1950-51 was 24 per cent while that of the private corporates and households at 72 per cent. Over the years, it may be seen that the share of the public sector rose till 1965-66 while that of private sector declined. The trend reversed and the share of public sector reached at 28.6 per cent in 1997 while that of private sector was at 71.4 per cent.
Section IV: The Structure of Financial System

A well-developed financial system is a precondition to economic growth. The structure of the financial system becomes important in determining the nature of growth. The Indian financial system has made rapid strides in facilitating intermediation, innovation of new instruments and institutions. The financial system is endowed with a large network of institutions and, particularly, over the past two decades has passed through different stages of development. The financial markets have facilitated the mobilisation and transfer of financial resources for various social and economic needs. The financial sector reforms have been undertaken in sequence so as to further deepen and widen the system keeping in mind the objectives of productivity and efficiency. With rapid advancement in technology, the crucial need to integrate various financial markets across the country has been recognised in order to signal monetary policy actions through the financial system.

The financial system in India is structured along traditional lines. The system comprises of the Reserve Bank of India as the central bank of the country, scheduled commercial and cooperative banks, post office savings banks, provident funds, and non-depository institutions, which can be further classified into All Financial Institutions, Mutual Fund institutions and Non-Bank Financial Institutions. All Financial Institutions can be sub-divided into development financial or term-lending institutions, Investment institutions, State-level institutions, and specialized institutions. The non-banking financial intermediaries can be further classified into
merchant banking, leasing, venture capital, housing, portfolio management and other miscellaneous services. The Reserve Bank of India being the central bank of the country, is primarily concerned with regulation of the monetary system so as to promote economic stability and to assist the growth process within the framework of Government’s planned development objectives.

One of the outstanding feature of the Indian financial system is its dichotomy into organised and unorganised sectors with a significant divergence in the interest rates. The financial system of India can be broadly classified into Organised sector and Unorganised Sector as follows:

I. The Organised Sector

India is endowed with an extensive financial infrastructure comprising of a vast network of financial intermediaries in the organised sector such as, banks and other financial institutions, deploying a variety of instruments in the process of financial intermediation. At the apex level, the Reserve Bank of India - the central bank of the country - plays a vital role as a regulator and promoter of the financial system. Besides, it has been active in promoting, developing and nurturing various financial institutions. The Bank has set up four corpuses of funds with annual allocations from its profits apart from providing refinance facilities for export credit. It also provides collateralized lending facilities to scheduled commercial banks and liquidity support to Primary Dealers, Satellite Dealers and gilt funds in government securities market (Chart I).
A. Banking System

The banking system is broadly classified into commercial and cooperative banks. The commercial banks are classified into scheduled and non-scheduled banks (Chart II). Scheduled banks are those banks which are included in the second schedule to the Reserve Bank of India Act, under which, a bank must have a paid-up capital and reserves of an aggregate value of not less than Rs.5 lakh; must satisfy Reserve Bank of India that its affairs are not being conducted in a manner detrimental to the interests of the depositors. In turn, the banks are eligible for certain facilities from the Reserve Bank of India. In the 'fifties of the 350 banking companies, 85 were scheduled banks. Modern banking thus emerged on the model of British Banking pattern with emphasis on branch banking.

The commercial and cooperative banks are functionally varied and geographically widespread. The commercial banks are organised in a unitary basis, with branches numbering 65,562 as at the end of March 1997 and are further classified into public sector banks (27), Indian private sector banks (34) and foreign banks (42). Besides, there are 196 Regional Rural Banks with 14,439 branches as at the end of June 1997 with the sponsorship of public sector banks that cater to the rural population such as small and marginal farmers, artisans etc. The commercial banks, while rendering banking services to 15 thousand people per branch office (March 1997), primarily engage themselves in mobilisation of savings and providing, working capital for industry, export-import, domestic credit, production credit for
agriculture, medium-term credit for various sectors besides, investing a substantial amount in government and other approved securities.

The cooperative banking system is divided into rural and urban cooperative banks with the former having a large network. The performances of the cooperative banks have been a cause of concern in the recent years in the context of financial reforms. Their credit structure is broadly classified into short-term and long-term and since 1982, the National Bank for Agriculture and Rural Development (NABARD) has become the apex institution for cooperative credit institutions. The short-term credit consists of a 2 tier and 3 tier system with apex banks at the State, Central and village level, while the long-term structure is either unitary or federal in character with State Land Development Banks (SLDBs), which have been rechristened as the State Cooperative Agriculture and Rural Development Banks (SCARDB) as the apex institution at the State level for long-term credit. Primary Land Development Banks (PLDBs), renamed as Primary Cooperative Agriculture and Rural Development Banks (PCARDB) are at the bottom level. The Primary (Urban) Cooperative Banks operate in the urban and semi-urban areas providing credit to small borrowers.

B. Financial Institutions

At the national level, there are (i) term lending institutions or development banks or development financial institutions, (ii) Investment institutions, (iii) specialized institutions, and (iv) State-level institutions. The term lending
institutions perform essentially two major functions, viz., financial and developmental. Under financial, loan assistance is provided in both domestic and foreign currencies. Generally, the development banks confine their lending operations to medium and long-term loans only. However, short-term assistance is provided only for working capital requirements and does not enter the area of commercial banking by providing short-term loans. Their major functions, include granting of loans and advances to industry, subscribing to and underwriting of their shares and debentures, guaranteeing loans raised by industrial concerns from the market or banks, deferred payments; foreign loans and credit arrangements etc. The loans and guarantees are to be backed by a pledge or mortgage or hypothecation or assignment of securities or other assets or by a guarantee from government or bank.

At present, the All India Financial institutions include, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India (in private sector), Industrial Finance Corporation of India, National Housing Bank, Export Import Bank of India, Tourism Finance Corporation of India and the Small Industries Development Bank of India. These institutions provide finance for large, medium and small scale industries through equity participations, loans and advances, refinance and rediscounting etc., besides providing non-financial services such as consultancy, training etc. At the state level, the State Finance Corporations extends finance like the national level institutions within their respective states with special emphasis on small scale industries and infrastructure facilities. The Industrial
Development Bank of India at the apex level coordinates the activities of all these institutions.

Furthermore, at the national level, there are three investment institutions in the public sector, viz., Life Insurance Corporation of India, General Insurance Corporation of India and the Unit Trust of India, which essentially functions as a mutual fund institution. The Life Insurance Corporation and General Insurance Corporation of India besides investing in government and other approved securities, provide loans to socially-oriented investments. The Unit Trust of India, besides mobilising savings through units also, underwrites and directly subscribes to shares and debentures and grants term loans. Insurance companies, investment trusts and other financial institutions also contribute to the mobilisation of small savings for large-scale capital formation. A large number of shares held by institutions under this category belong to the Life Insurance Corporation.

The Export Import Bank of India, the National Housing Bank, the Small Industrial Development Bank of India and the Tourism Finance Corporation of India serve as the specialised institutions for export-import, housing, small industries and tourism promotion respectively, apart from risk capital (Risk Capital and Technology Finance Corporation) and Technology Development (TDICl) Companies. The other institutions include, Export Credit Guarantee Corporation of India and Deposit Insurance and Credit Guarantee Corporation of India. These comprise the State Financial Corporations / Institutions and the State Industrial Investment
Corporations. The State Financial corporations occupy a unique place among other development banks in India. Their functions are influenced by the respective state Governments and Reserve Bank of India. The State Finance Corporations Act have been amended in 1955, 1956 and 1962 which had enhanced the powers and scope of functioning of the State Finance corporations. Over the period of 45 years about 18 State Financial Corporations have been established in different states with the primary objective of providing long and medium term loans to small and medium scale units. The share capital of the State Financial Corporations is subscribed by the respective state governments, Reserve Bank of India and other financial institutions. The other financial resources include, reserves, bonds, debentures, borrowing and deposits. Loans and underwriting assistance are provided to projects with paid up capital and reserves up to Rs. 1 crore. The maximum assistance provided to a single unit is placed at Rs. 30 lakh. Unlike Industrial Finance Corporation of India, State Financial Corporations are not permitted to directly subscribe to the shares and stock of any company.

C. Mutual Funds

The concept of mutual funds first originated in the United Kingdom and the United States in the 19th Century with the formation of large investments trusts. An economics dictionary defines mutual funds as "The American term for Unit Trusts". Thus, mutual funds institutions are investment unit trusts and are in a sense a non-banking financial intermediaries. Mutual funds generally pool savings of different types of investors by selling units either in tap or in block form and invest these
funds in a variety of securities. Thus, mutual funds provide the following advantages to the investors:

- Facilitate small investors to share the benefits of a wide portfolio of investment.
- They pool and spread risks thereby facilitate the small investors with no specialised skills of risk management to invest their small savings.
- They provide a reasonably attractive rate of returns.
- The holders of units are not the shareholders and the holders can easily buy and sell units either to the institution or through the stock exchanges.

The Finance Bill of 1988 amended (i) Section 80cc of the ITA in order to provide deduction to investment in units of any mutual fund set up by public sector banks or other financial institutions provided such funds subscribed only to “eligible issue of capital” as defined in sub-Section (B) of Section 80cc; (ii) Section 80L of ITA to provide similar benefits on interest/dividend income. The mutual funds, besides being permitted to invest in corporate securities, were also permitted to invest in any commercial paper (CP) or security floated by the Central Government, Reserve Bank of India or any local authority, foreign Government, foreign bank or any other authority outside India as approved by Reserve Bank of India. Besides, under Section 18 of the Public Debt Act, 1944, mutual funds were permitted to invest in Government Sector as defined therein.

Mutual funds are broadly classified into (i) open-ended and (ii) close-ended funds. In the case of open-ended funds, the period and/or amount invested is indefinite. The periodic issues of the same scheme are made and repurchases are
effected in a continuous basis. Close-ended funds have definite number of limits with a target amount sold only at a one-time basis to the investors. The subsequent transactions are permitted in the secondary market. World-over, it has been found that the open-ended funds offer relatively lower returns as compared with the well managed close-ended funds. Mutual funds, based on the objectives of the schemes can be further sub-classified into (a) Income-oriented; (b) Growth-oriented and (c) Equity-oriented.

Within a short span of time, a number of mutual funds with a variety of schemes have emerged, which have been either banks-sponsored, financial institution-sponsored or from the private sector. The total resources mobilised by them amounted to a peak level of Rs. 11,275 crore in 1994-95 which came down substantially to Rs. 3,305 crore in 1997-98 due to adverse market conditions.

D. Non-Banking Financial Companies

In the financial structure of institutions, the non-banking financial institutions have gained substantial importance in the financial system by mobilising deposits and rendering financial assistance to the household sector. The share of non-bank deposits of these institutions in the gross household savings increased from a low of 2.9 per cent in 1957-58 to 13.6 per cent during 1996-97. This is indicative of their importance in the intermediation process especially where even the established financial entities could not be easily accessible to borrowers.
The scope for banks to set up subsidiary companies dealing with mutual funds was prohibited as 19(I) of the Banking Regulation Act, 1949. With the suggestions of Indian Capital Market in 1987, the Government of India and Reserve Bank of India introduced a series of policy measures in order to activate the capital market and encourage investment in the industrial sector so as to accelerate the pace of growth and modernisation. One such measure was the setting up of mutual funds in order to provide opportunities for small investors to contribute towards development of the capital market. The Prime Minister’s Budget Speech in February 28, 1987 announced for the first time the setting up of mutual funds in the country. Fiscal reliefs on investments in the industrial sector were given.

With the launching of the Seventh Five Year Plan (1985-90) in the country, the industrial and financial policies were liberalised. Consequently, banks and financial institutions diversified their activities into fresh areas such as merchant banking, equipment leasing, venture capital, factoring, mutual funds and other forms of financial services, by setting up separate subsidiaries. It gave way to the emergence of many new institutions, asset management companies, debt rating institutions such as Credit Rating and Information and Credit Rating Agency of India (ICRA) and Credit Analysis and Research Limited (CARE) etc.
F. Primary and Satellite Dealers

The system of Primary Dealers (PDs) and Satellite Dealers (SDs) in the Government securities market was established by the Reserve Bank of India in 1995. At present there are 15 primary dealers in operation. The primary dealers serve as market makers in the Government securities market by offering two-way quotes. Their presence has brought about an element of dynamism in the primary and secondary markets. The Satellite Dealers were set up in 1997 after the Reserve Bank announced guidelines on December 31, 1996 with the objective of serving as a second-tier in trading and distribution of Government securities. At present there are 9 satellite dealers in operation.

II. Unorganised Sector

The Unorganised sector comprises indigenous bankers and moneylenders. Prior to the advent of the British in India, the banking activity was undertaken by indigenous bankers and agricultural finance by money-lenders. Despite the development of organised Commercial and Co-operative banking and Development Financial and several other specialised institutions over the last fifty years, indigenous bankers and moneylenders occupy an important place in the Indian financial system. However, detailed information about them is not available. The Indian Central Banking Enquiry Committee defined indigenous bankers as “any individual or private firm receiving deposits and dealing in Hundis or lending money ...” and moneylenders as “those whose primary business is not banking but money lending” (Government of India, 1931).
However, it has been a problem to distinguish between the two because in many States several money-lenders received deposits while indigenous bankers did not accept deposits and nevertheless they were respectively termed as money-lenders and indigenous bankers. In this regard, the Banking Commission observed that, "while the former lends his own funds, the latter acts as a financial intermediary by accepting deposits or availing himself of bank credit; in other words, the indigenous banking system is regarded as a true financial intermediary in the sense that its ability to purvey funds is largely dependent on the outside sources it is able to mobilise. Another distinguishing feature is that the transactions of the money lender are conducted in cash while those of the indigenous banker are based on their dealings in short-term credit instruments for financing the production and distribution of goods and services." (Government of India, 1972).

The indigenous bankers provide finance to those small traders and industrialists in the urban areas who were not regarded as credit-worthy by banks. They lend against collateral or on personal security. They indirectly lend to the agriculturalist through local merchants and money-lenders for movement of crops. They also undertake trading activities. The money-lenders on the other hand, directly lend to agriculturalists, tenants and labourers. They provide finance for marketing the crops and also extend short-term and long-term credit for various purposes. They also provide loans for consumption purposes.
Lastly, the unorganised sector in India plays an important role in financing agriculture in the rural areas, and business/trade in the semi-urban and urban areas. However, its overall size of operations continues to be insignificant when compared with those in the organised sector.

Section V: The Structure of Financial Markets

The financial markets forming an integral part of the financial system play a significant role in facilitating financial intermedation. It is evident from the theories of "endogenous growth" that strong linkages exist between financial intermediation and economic growth (King and Levine, 1993a, b, c). Moreover, the process of financial intermediation compliments increases in capital accumulation through institutionalisation of saving and investment reflected in certain financial deepening ratios, such as, the financial ratio, financial inter-relation ratio, intermediation ratio etc. (Rangarajan, 1994). With the rapid growth and diversification of the Indian Financial System, particularly during the last two decades, the financial markets have widened and have paved the way for the emergence of many new and innovative instruments in the process of financial intermediation, which in turn, has facilitated the mobilisation and transfer of financial resources for various social and economic needs.

Based on the structure of the financial system, the financial markets can be broadly classified into following categories (Chart III). (i) organised credit market, (ii) call-money market, (iii) capital market consisting of primary and secondary
segments, (iv) debt market comprising government securities, Public Sector Undertakings bonds and corporate debentures, (v) housing finance market, (vi) hire purchase and leasing finance market where non-banking financial intermediaries predominate, (vii) insurance market, (viii) informal finance - where information is limited and cannot be easily ascertainable, and lastly (ix) the foreign exchange market (Chart III). Of these, the important ones are reviewed below:

A. Money Market

The short-term money market segment of the financial system can be categorised into five sections as follows:

(i) **Call-money market**: this is the most responsive segment and is highly volatile as the prices and volumes traded affect the finances of the State and Central governments, banks and other institutions. It also serves as a market for signaling policy actions of the central bank and also enables conduct of the open market operations by the central bank;

(ii) **Inter-bank deposit market**: it is the core of the inter-bank market centralised at Mumbai with sub markets at Calcutta, Chennai, and Delhi. The inter-bank money loans are unsecured in nature and are subject to internal limits of the banks;

(iii) **Inter-corporate deposit market**: which operates freely and is outside any regulatory framework with maturity ranging between 3 to 6 months and are unsecured loans. The interest rate vary depending upon
credit rating of the companies and the loans are generally placed by the merchant bankers;

(iv) **Bills Discount Market**: where genuine trade bills maturing within 90 days are eligible for discounting, did not develop in India inspite of introducing a bill market scheme as early as in 1952. In the ‘sixties, it was reintroduced but the market was activated only in the late ‘eighties with the introduction of new instruments, such as, commercial paper (CPs), Certificate of Deposits (CDs), Inter-bank participation Certificates (IBPs) etc., and lastly,

(v) **Treasury Bills Market**: which become active in the ‘nineties with the introduction of several measures in the process of reforms in the financial sector and activisation of the government securities market since 1992. At present there are 14-day, 91-day, 182-day and 364-day auction treasury bills.

**B. Debt Market**

The debt market can be further classified into (a) Government Securities Market (b) Public Sector Undertakings (PSU) bonds and (c) Corporate bonds. Of these, the Government Securities Market is the largest where several developments have taken place.

Until recently, the government securities market India was a captive market characterised by administered interest rates. It was only since 1991, steps were
initiated to activate the government securities market. As part of the financial sector reforms, the government took conscious decision to borrow at a market-related rates. Earlier, budgetary deficits were financed by automatic creation of ad-hoc treasury bills by the central bank, which led to the monetisation of the budget deficit. Secondly, the Government of India and the Reserve Bank of India entered into an agreement to phase out automatic monetisation of the budget deficit by eliminating the use of ad hoc treasury bills. Several measures have been introduced in the government securities market. A system of auction of treasury bills was introduced in 1992. A number of innovative instruments, such as, conversion of treasury bills, Zero Coupon bonds, Tap Stock, partly paid stock and floating rate bonds have been introduced to activate the government securities market. The Repurchase Agreements (Repo) market was expanded. A system of Delivery versus payment was introduced in 1994. Ways and Means Advances limits were fixed for Central and State Governments. Open market operations were activated by taking devolvements in the primary market and offloading the same through the open market window. Foreign institutional investors were permitted entry into the market.

C. Capital Market

India's capital market is among the largest in the developing economies with 22 stock exchanges trading in shares, debentures and long-term government debt. The number of companies exceeds 7,000 which is only next to the US Stock market catering to over 15 million investors. The market capitalisation as percentage of GNP is over 70 per cent. The capital market in India expanded and diversified only
since the 'eighties. Recently, the capital market developments have seen a sea change with the entry of foreign institutional investors. Further forward trading has been reintroduced and the National Securities Depository limited was set up as a depository institution, which has enabled trading in a dematerialized form. The primary market and the secondary markets have expanded rapidly in the recent years. One important development was the establishment of the Securities Exchange Board of India (SEBI) as a statutory body in 1992 with the responsibility of regulating and developing the securities market in India. Secondly, in order to make the transactions transparent, the Bombay Stock Exchange introduced a screen-based trading system known as Bombay Stock Exchange on-line Trading System (BOLT) since March 14, 1995. Another significant step was the commencement of trading on the National Stock Exchange (NSE) in the wholesale debt market and capital market segments during 1993-94. The over the counter Exchange of India was established to enable transparency and speedy transactions in the capital market. With the setting up of the depository institutions, trading in a dematerialised form has been facilitated.

Section VI: The Indicators of Financial Development

The pervasiveness of financing economic activities thereby stimulating growth may be indicated by several ratios. One such ratio at any period of time is the ratio of financial assets to Gross Domestic Product. In the economic sense, while the stock of financial assets, its distribution and types are affected by its flows in any period of time, the flows of financial assets produce changes in stocks. Thus,
these relationships relate to the real and current flows of financial variables. Apart from the matrix of financial stocks or construction of a national balance sheet (Venkatachalam and Sharma, 1976), which relates to a point of time, there is a flow of funds matrix relating to any period of time. However, although the purpose is not to construct a national balance sheet, the focus is on point of time observations of financial stocks. The financial structure comprises financial stocks of various financial assets along with different types of financial institutions in existence. As the financial structure is a composite of institutions, the measure of financial structure would involve several indicators.

According to Goldsmith (1969), major indicators of financial development are as follows:

(a) **Finance Ratio (FR):** It is the ratio of total financial claims (financial issues) to national income. It serves as an indicator of the rate of financial development vis a vis rate of economic growth. A higher rate indicates the importance of the financial structure. The finance ratio in India increased marginally at a slow pace from 0.01 in 1950-51 to 0.41(estimated) in 1996-97.

(b) **Financial Intermediation Ratio (FIR):** It is the ratio of total assets to national wealth (real assets plus net claims against rest of the world). Higher this ratio, greater is the level of financial development. Alternatively, it is the ratio of total volume of financial assets at any point of time to the stock of physical assets. It therefore, reflects the basic aspects of the country's
financial structure and development, namely, the relationship between its financial structure and its real asset structure. It is computed on the basis of change in the volume of financial asset during any period and capital formation. The FIR has shown steady increase from 0.09 in 1952 to 2.04 (estimated) in 1997.

(c) **New Issue Ratio (NIR):** This ratio indicates the extent to which non-financial sector finances its investments through funds obtained by it. This is measured as the ratio of primary issues to net capital formation. Primary issues are defined as claims issued by those in the non-financial sector or real sector. This ratio increased from 0.08 in 1951-52 to 1.43 (estimated) in 1996-97.

(d) **Intermediation Ratio (IR):** It shows the importance of financial institutions relative to non-financial units in raising resources to finance investments. It is measured by the ratio of volume of financial instruments issued by financial institutions called as secondary issues to volume of primary issues by non-financial units. This provides the measure of institutionalization of financing of an economy. This ratio increased from 0.34 in 1954 to 0.81 (estimated) in 1997.

Section VII: Financial Sector Reforms

The financial sector reforms have been undertaken in three stages. In the first stage, several measures were introduced since the mid-eighties based on the recommendations of the Committee to review the Monetary System (or the
Chakravarty Committee, 1985) and the Working Group on Money Market (or Vaghul Committee, 1987). These include, freeing of the money market rates viz., call money, notice money, inter-bank deposits and bills rediscounting since 1989; permitting All India financial institutions such as development banks and investment institutions to participate in the money market as lenders; introduction of a variety of instruments such as 182 day treasury bills, Certificates of Deposits (CDs), Commercial Paper (CPs) and Inter-Bank Participation Certificates (IBPCs); the setting up of the Discount and Finance House of India to even the short-term liquidity fluctuations in the money market; rationalisation of the term structure of interest rates by reducing the short-term rates; raising the maximum coupon rate on government securities in stages and reduction of the maximum maturity period from 30 years to 20 years.

In the second stage, reform measures were introduced based on the recommendations of the Committee on the Financial System (or the Narasimham Committee, 1991). These include, reduction in the Statutory Liquidity Ratio (SLR) to 25 per cent and a progressive reduction in Cash Reserve Ratio (CRR); deregulation of interest rates so as to reflect emerging market conditions; Stipulation of minimum capital adequacy ratio; a board of financial supervision within the Reserve Bank was set up to implement uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts; imparting transparency to bank balance sheets and making full disclosures; setting up of special tribunals to speed up the process of recovery of loans;
restructuring of the Banking System so as to have three or four large banks which could become international in character, 8 to 10 national banks and local banks confined to specific regions along with rural banks including RRBs confined to rural areas; abolition of branch licensing and liberalising the policy with regard to allowing foreign banks to open offices in India; emphasis was placed on technology and computerisation; the regional rural banks were restructured; licensing of new cooperative banks was liberalised and National Cooperative bank of India was established as a multi state cooperative society; system of credit delivery to the small scale industries was an important part of financial sector reforms; attention was given to eliminate frauds and malpractices in banks; term lending institutions were put under prudential regulation. The Committee also recommended proper sequencing of reform of financial system.

In the third stage, the Committee on Banking Sector reform (Narasimham committee II) was constituted in December 26, 1997 to review the progress of implementation of the financial sector reforms, which began in 1991. In pursuance of its recommendations, several measures were introduced. These include foreign exchange open position carried a 100 per cent risk weightage since March 31, 1999; prescription of a 5 per cent risk weightage for Government/approved securities since March 31, 2000; minimum capital adequacy ratio for banks was raised to 9 per cent; Government guaranteed advances which turned sticky are to be classified under Non Performing Assets (NPA); banks were advised to reduce non-performing assets (NPAs) and put in place risk management systems and practices and a formal
asset-liability management systems; interest rates on domestic term deposits; and lending rates deregulated; prudential guidelines were issued to non-banking financial companies. Besides, banks were given the freedom to fix separate prime term lending rates and relaxation was given for money market mutual fund investments in corporate bonds and debentures.

In furtherance to the financial sector reform initiatives, the Government appointed a Committee on Reforms in the insurance sector in April 1993. Based on its report, the Government has given substantial autonomy to the insurance companies. The passing of the insurance reforms bill would further liberalise the insurance sector.

Section VIII: Regulatory Framework

Several statutes govern the financial system in India. Earlier, the control over capital issues was introduced in the Second World War for the first time in May 1943 under the defence of India Rule to prevent diversion of scarce resources to other activities which made little or scant contribution to the prosecution of the war. It also aimed to maintain the production of essential goods and services for mass consumption.

In the 'fifties, many important developments took place in the regulatory framework. The First Industrial Policy resolution coincided with the launching of the Second Five Year Plan. The Securities Contract (Regulation) Act, 1956 and the
Companies Act, 1956 were introduced. The Capital Issues (Continuance of Control) Act was passed in April 1947 and in 1956 it was permanently placed in the statute book. However, it was abolished in the mid eighties.

The banking sector is governed by the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The Government securities market is governed by Public Debt Act, 1944, Securities Contract (Regulation) Act, 1956, Companies Act, 1956 and the Securities Exchange Board of India Act, 1992. Recently, the Reserve Bank of India and Securities Exchange Board of India's powers were demarcated with the former dealing with the Government securities and the latter dealing with the capital market and stock exchanges. While these Acts have undergone several amendments according to the needs of the changing financial and technological environment, the Public Debt Act, 1944 is being replaced by a new Government Securities Act in view of the various technological developments and innovations in the Government securities market for which there is no provision in the former.

The capital market continues to be governed by Securities Contract (Regulation) Act, 1956, Companies Act, 1956, and SEBI Act, 1992. Besides, there exist Statutes of public financial institutions, which govern the individual institutions such as Unit Trust of India Act 1964, Regional Rural Banks Act, 1976 etc. Besides, the Non-Banking Financial Companies operating in India for a long time were regulated only since the 'sixties. Several Committees were constituted to regulate

Section IX: Summary and Concluding Observations

One of the major objectives of financial reforms in India has been to integrate financial markets so as to transmit monetary policy actions through the financial system. This can be through the rates of return on the financial assets with the institutions facilitating movement of funds. The commercial banks are an important segment of the financial system. A need has arisen to facilitate market-determined credit allocations, which is possible if other markets develop.

The Indian Financial System has made rapid strides in facilitating intermediation, innovation of new instruments and institutions. It has played a key role in integrating various financial markets in the country particularly since the era of planning for economic growth. During the last four decades, the number of financial intermediaries has grown and there variety of new instruments to cater to the varied interests of the investing community. A number of the specialized financial institutions have emerged which have broadened and deepened the financial system as a whole.
The characteristics of the financial sector have undergone a sea change. Till the mid 'eighties, there was a administered structure of interest rates, which was liberalised and deregulated in phases subsequently along with the introduction of financial sector reforms. The financial system that was dominated by the banking system till the eighties, at present comprises of a well diversified network of institutions as India has been following a multi institutional approach to industrial and agricultural financing. As compared to the earlier decades, the number of institutions has more than doubled and diversified into non–traditional activities. Technological developments which were minimal or non existing prior to mid 'eighties became advanced in the later period. Lastly, the financial sector reforms have been an ongoing one and introduced in stages to suit the macroeconomic conditions and plan objectives. The financial markets are getting more and more integrated particularly since the 'nineties. Moving away from branch licensing policy, more freedom was given to open branches and also the emergence of new private sector banks. Emphasis was placed on transparency, adherence to accounting norms and to other prudential norms.

Aided by technological developments and financial sector reforms, efforts are on to bring the Indian financial sector to the international standards with respect to viability, competitiveness, prudential requirements, regulation and credibility so as to place India in the map of important emerging economies.
CHART III.2

FINANCIAL SYSTEM: BANKING STRUCTURE

ORGANISED

RBI

COMMERCIAL BANKS

COOPERATIVE BANKS (NABARD)

MONEY LENDERS

INDEGENOUS BANKERS

SCHEDULED

NON-SCHEDULED

RURAL

PRIVATE SECTOR

PUBLIC SECTOR

LONG-TERM

SHORT-TERM

INDIAN BANKS

FOREIGN BANKS

SBI & 7 ASSOCIATES

UNITARY SLDB/SCARDB

FEDERAL SLDB/SCARDB

2-TIER STATE (SCBs)

FEDERAL SLDB/SCARDB

PLDB/PCARDB

2-TIER STATE (SCBs)

PRIMARY (URBAN)

INDIAN BANKS

REGIONAL RURAL BANKS

NATIONALISED BANKS

REGIONAL RURAL BANKS

DISTRICT (CCBs)

PACS

PACBS

PACS

223
Table III.1: Sectoral Composition of Gross Domestic Savings (at Current Prices)

(Rs. crore)

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Sector</th>
<th>Private Corporate Sector</th>
<th>Household Sector</th>
<th>Total</th>
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<td></td>
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<td>% to GDS</td>
<td>% to GDP</td>
<td>Amount</td>
</tr>
<tr>
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<td>89</td>
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<tr>
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<td>657</td>
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P: Provisional.
Table III.2: Composition of Savings of the Household Sector (at current prices)

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<td>Amount</td>
<td>% to Total</td>
<td>Amount</td>
</tr>
<tr>
<td></td>
<td>(Rs. crore)</td>
<td>% to GDP</td>
<td>(Rs. crore)</td>
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P: Provisional.
Table III.3: Savings of the Household Sector in the Form of Financial Assets (at current prices)

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<tr>
<th>Year</th>
<th>Financial Assets</th>
<th>Currency Deposits</th>
<th>Bank Deposits</th>
<th>Non-Banking Deposits</th>
<th>Insurance fund</th>
<th>Units of UTI</th>
<th>PFs</th>
<th>Govt.</th>
<th>Shares/Debentures</th>
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<td>80</td>
<td>10</td>
<td>-</td>
<td>21</td>
<td>-</td>
<td>9</td>
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<td>85</td>
<td>-</td>
<td>67</td>
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P: Provisional.