Role of Financial Services in Economic Growth of India

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Abstract

This paper analyzes the role of financial services in mobilizing savings for economic growth in India. The paper shows that economic growth of India has speeded up by fast growth in financial services. The improved provision of financial services lead to enhanced savings which are channelized in productive enterprises to generate income and employment avenues for the nation's youth (both skilled and unskilled) which ultimately lead to economic development of an economy.

Introduction

A striking feature of India's growth performance over the past decade has been the strength of the service sector. The increase occurs along with an increase in the share of industry. India's growth experience has been characterized by a decline in the share of agriculture in GDP and an increase in the share of industry and services. Between 1951 and 2012, the share of agriculture in GDP fall from 58% to 14% while the share of industry and services increased from 15% to 27% and from 25%to 59%, respectively.

Contribution of various sectors in the GDP of India:-

Year Sector	1950-51 (%)	1980-81 (%)	1990-91 (%)	2005-06 (%)	2011-12 (%)
Agriculture	58	38	32	20	14
Industry	15	24	27	26	27
Service Sector	25	38	41	54	59

Source - Compiled from Central Statistical Organisation

It is great that today the service sector is contributing more than half of the Indian GDP. It takes India one step closer to the developed economies of the world.

Service sector comprises of various sub sectors like financial services, hotels, transportation, communication, information technology and tourism etc. Financial services refer to the services provided by the finance industry to the nation. The finance industry encompasses abroad range of organizations that deal with the management of money. Among these organizations are credit unions, banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds, leasing companies, factoring companies and some government sponsored enterprises.

The financial services have been gaining increasing importance in today's rapidly globalizing economy. The financial services are recognized for its contribution towards long term growth and efficiency given its intermediate role in channeling resources to all sectors of the economy. Improved provision of financial services enables greater efficiency in other sectors by expanding the range and enhancing the quality of such services, by lowering costs of funds and by encouraging savings and more efficient use of these savings. Financial services has contributed 15% to India's GDP in FY 2009 and is second largest after trade, hotels, transport, communication all combined together.

Table showing Financial Services Growth Rates and Sectoral Share in **GDP**

Sector	**Activities Included**	**Avg. Growth Rate in 1950–79 (Share in 1980)**	**Avg. Growth Rate in 1980–89 (Share in 1990)**	**Avg. Growth Rate in 1990–99 (Share in 2000)**	**Avg. Growth Rate in 2000-06 (Share in 2006)**
Banking	Banks, banking department of RBI, post office saving bank, non-bank, financial institution, co-operative credit societies, employees provident fund	7.2 (1.9)	10.0 (3.3)	10.6 (5.0)	7.6 (5.6)
Insurance	Life, postal life, non life	7.1 (0.55)	9.6 (0.62)	2.2 (0.61)	14.3 (1.1)
Dwellings, real estate		2.6 (4.5)	7.2 (5.8)	4.8 (5.2)	2.5 (3.9)

Business services	Renting of machinery, computer related services, accounting, research etc.	4.2 (0.42)	9.1 (0.7)	15.9 (2.1)	17.3 (3.6)
Legal services		2.6 (0.13)	8.1 (0.2)	5.6 (0.2)	3.6 (0.14)

Source: http://www.icrier.org/pdf/Working%20Paper%20249.pdf

The objective of this paper is to evaluate the role of financial services in mobilizing saving for economic growth in India.

The financial services help in the reallocation of capital and thus provide continuous restructuring of the economy needed to support the growth. This study limits to the trend and growth in the pattern of household savings in India. The financial service providers provide four key financial services for expanding economic opportunity of the growing, young, innovative and high technology firms. These four key financial services are as follows:

- Creating inclusive business models
- Developing human capital
- Building institutional capacity
- Helping to optimize the "Rules of the Game"

Creating Inclusive Business Models:- The inclusive business models means providing financial aid to economically viable projects like venture capital funds, small and medium scale enterprises (SME) finance and supply chain finance etc. The financial institutions provide money to inclusive business models which is saved and deposited by the general public. Inclusive business models provides opportunity for general public to serve as employees, entrepreneurs, suppliers, distributors, retailers, customers and source of innovation in financially viable ways.

Developing Human Capital: - Developing human capital means improving the health, education, experience and skills of employees, business partners and members of the community. Large financial institutions are engaging in human capital development activities to expand economic opportunity directly (for instance, through financial and business

management training for SMEs and financial literacy programs for individual clients) and indirectly (by supporting public education and leadership programs.)

Building Institutional Capacity:-It includes strengthening the industry associations, market intermediaries, universities, governments, civil society organizations and grassroots groups who must be able to play their roles effectively within the system.

For Example:- ICICI Bank in India provides a good case study in institutional capacity building, as it is working on a number of levels.

- **Micro Finance Institution**: - ICICI bank is building a network of MFIs that have local information and sufficiently low cost structures to support small transaction sizes. ICICI bank provides capital for on-lending as well as equity capital for growth; product development help; and linkage with capital market as the MFIs mature.

- **Credit Rating Agencies**: - ICICI has joined with Dun and Bradstreet, Standard Chartered and several national banks to create the SME Rating Agency of India Ltd.(SMERA) to provide comprehensive, transparent and reliable ratings, facilitating easier flow of credit from the banking sector to SMEs.

- **Research Centres**:- ICICI helped found the non-profit Institute for Financial Management Research (IFMR), which houses six research centres that conduct market research, design and test emerging business models and methodologies, widely disseminating its results. IFMR has also established a leading business school.

Helping to optimize the "Rules of the Game":- It means shaping the regulatory and policy framework and business norms that help determine how well the economic opportunity system works. Financial service firms can influence regulatory and policy framework in ways that promote economic opportunity by engaging individually or collectively, in dialogue with policymakers in areas such as business entry and exit rules, infrastructure requirements, trade and investment policy and financial sector regulation.

Review of Literature

The importance of financial services in promoting economic growth has been studied extensively in the literature. Economic history contains many examples of linkages between financial sector development and economic growth. Entrepreneurs require credit in order to finance the adoption of new production techniques. Banks are viewed as key agents in facilitating these financial intermediating activities and promoting economic development. Hence well developed financial system can channel financial resources to the most productive uses.

Ahmed and Ansari (1998) investigated the relationship between financial sector developments & economic growth for three major South Asian economies namely India, Pakistan and Sri Lanka. The results indicated a high degree of association between financial sector developments, economic growth and strong support for the supply ready hypothesis i.e. financial development caused economic growth. The main policy implications that followed from this study was that governments in these countries could help promote economic growth by encouraging financial sector development through further liberalization measures.

Calderon and Liu (2003) examined the direction of causality between financial development and economic growth. Using the Geweke Decomposition Test on pooled data of 109 developing and industrial countries from 1960 to 1994 the researcher found that financial development lead to economic growth through both rapid capital accumulation and productivity growth and financial deepening contributed more to the causal relationships in the developing countries than in the industrial countries. Moreover, the Granger causality from financial development to economic growth and from economic growth to financial development coexisted.

Fase and Abma (2003) examined the empirical relationship between financial development and economic growth in nine emerging economies in the south East Asia. The finding indicated that a policy of financial reform was likely to improve economic growth.

Liang & Teng (2006) investigated that relationship between financial development and economic growth for the case of China over the period of 1952 to 2001. The empirical results suggested that there existed a unidirectional causality from economic growth financial development, conclusions departing distinctively from those in the previous studies.

Liu and Hsu (2006) examined the relationship between financial sector development a d the source of growth of three Asian economic, namely Taiwan, Korea and Japan. The result of the study highlighted that higher growth rates were not necessarily associated with higher investment ratios but were accompanied by higher growth rates of employment and real export, liquidity of the stock market and sound financial system.

Ang (2008) made an attempt to find out the mechanisms linking financial development and economic growth in Malaysia. The result indicated that financial development lead to higher output growth via promoting private saving and private investment. Moreover, repressionist financial policies such as interest rates controls, high reserve requirements and directed credit programmes had contributed positively to financial development. While other government interventions in the economy such as resource allocation through the operation of a broad based employee provident fund scheme and various public investment programmes seemed to have impacted negatively on economic development in Malaysia.

Fung (2009) in his study tested for convergence in the financial development and economic growth by incorporating the interaction between the real and financial factor into and otherwise traditional for conditional conveyance. The results suggested that the mutually reinforcing relationship between financial development and economic growth was stronger in the early stage of economic development. Moreover, low income countries with a relatively highly developed financial sector were more likely to catch up to their middle – High income counterparts and poor countries with a relatively under developed financial sector were less likely to catch up.

Wu, Hou and Cheng (2010) studied the dynamic impacts of financial institutions on economic growth based on a panel data set comprised of 13 countries in European union over the period of 1976 to 2005 .The results of the study highlighted that there existed a long run equilibrium relationship among banking development, stock market development and economic development. Moreover, stock market capitalization and liquidity had positive long run effects on economic developments.

Kar, Nazlioglu and Agir (2011) investigated the direction of the causality between financial development and economic growth in the Middle East and North African countries. The results stated that Granger causality from financial development to economic growth and from economic

growth to financial development coexisted, but the direction of causality seemed to be country and financial development indicators specific.

Analytical Framework

There are good reasons to believe that financial services lead to economic growth of a nation. The aim of my analysis is to evaluate the role of financial services in mobilizing saving for economic growth in India. To measure the Economic development I have taken the data regarding the household savings which are invested in various financial products available like bank deposits, units of UTI life insurance fund, and claims on government. This investment leads to increase in Net Capital Formation.

The investment pattern of people is changing over the period of time. Bank deposit , Life Insurance Fund, Provident And Public Fund are increasing over the period of time as people want to be secure in the old age and want their investment to be in the least risk while the claims of the people on the government shows a decreasing trend because it is totally risk free so return is also low. The investment in shares and debentures is falling over the period of time due to security scams and high risk in the capital market. It indicates that people have adopted a moderate investment pattern over a period of years which is neither risk free nor of high risk.

The investment pattern of Household savers in India in various financial products is highlighted through tables and charts as shown on next pages.

Table 1

Table Showing Changes in Financial Assets of the Household Sector (Rupees crores)

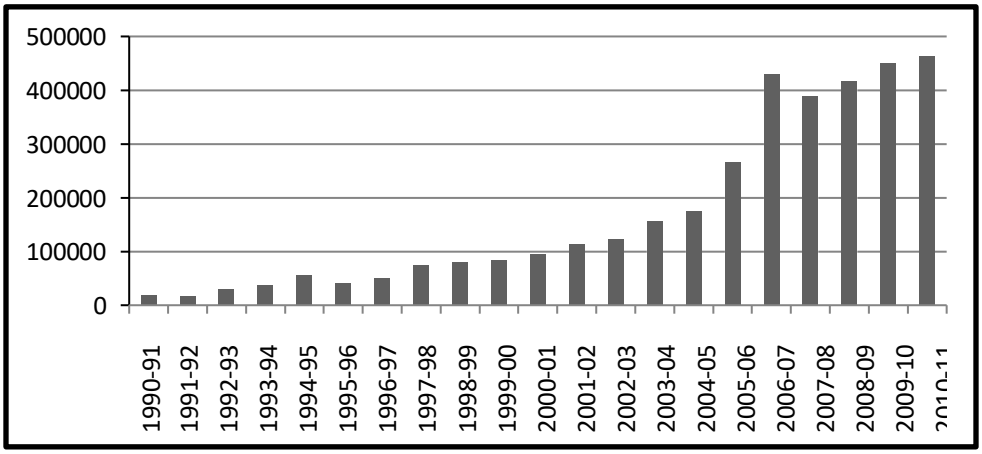
Year	Bank deposits	Non-banking deposits	Life insurance fund	Provident and pension fund	Claims on Govern-ment	Shares & debent-ures	Units of UTI
1990-91	18777	1286	5599	11155	7883	4972	3438
1991-92	17848	2218	7003	12501	4845	6800	9087
1992-93	29518	6035	7114	14814	3885	8212	5612
1993-94	36236	11654	9548	18323	6908	10067	4705

1994-95	55835	11547	11370	21414	13186	13473	3908
1995-96	39941	13198	13894	22343	9588	8839	262
1996-97	50902	25980	16121	30390	11783	6631	3776
1997-98	74099	6733	19410	32267	22162	4464	595
1998-99	79433	7670	23428	46408	28220	5105	1887
1999-00	82892	3844	28644	53907	28985	16308	1811
2000-01	94709	3004	33861	50863	39007	11148	-934
2001-02	113033	-347	41237	44223	51938	9834	-1857
2002-03	122697	12496	52009	45946	56087	7123	-1618
2003-04	155934	1945	52240	48952	87372	9078	-8586
2004-05	175045	83	67986	55794	106420	8113	-3146
2005-06	265716	522	83494	61950	87168	33857	-444
2006-07	429282	4584	114851	72503	19198	50847	-310
2007-08	389008	1286	169848	71544	-28327	74308	-324
2008-09	417833	14742	152861	73398	-27551	-2333	-2737
2009-10	449453	19220	224487	114369	42873	47359	-2021
2010-11	463992	30343	252918	95159	67954	-4636	0

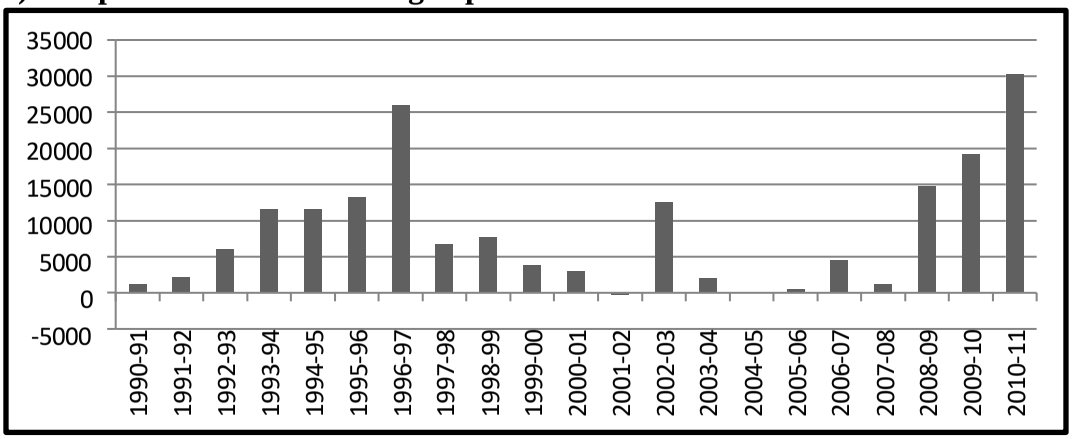
Source - Compiled from http://www.rbi.org.in

Chart 1

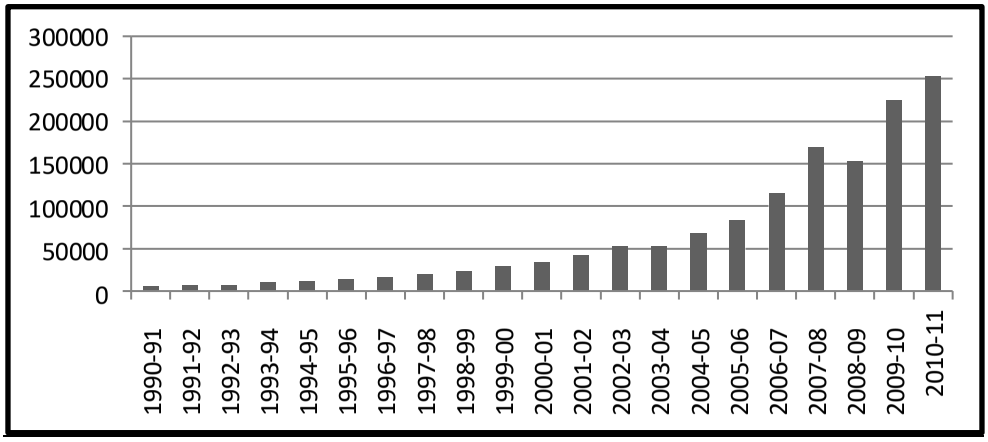
(a) The pattern of bank deposit investment of India from 1990-2011.



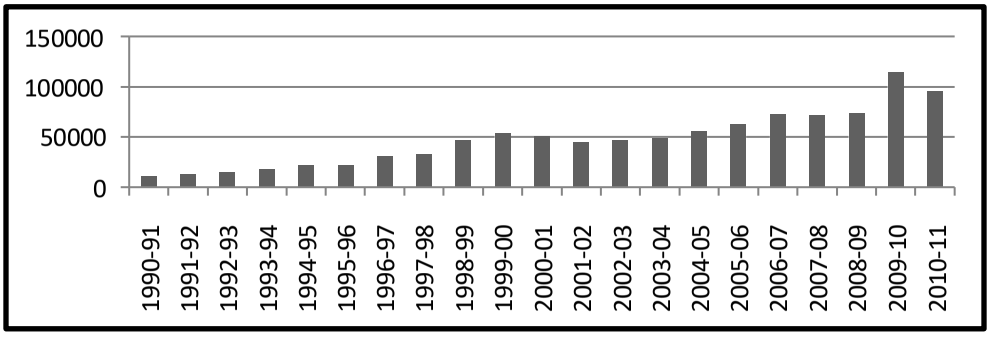
(b) The pattern of non- banking deposit investment of India from 1990-2011.



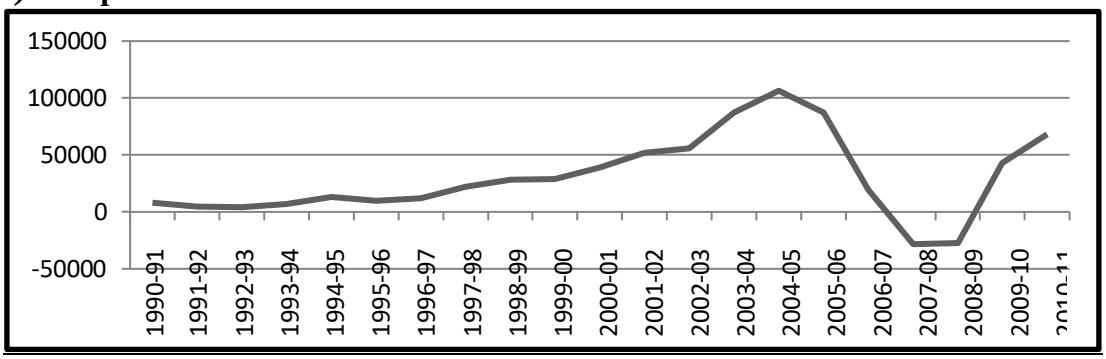
(c) The pattern of life insurance fund investment of India from 1990-2011.



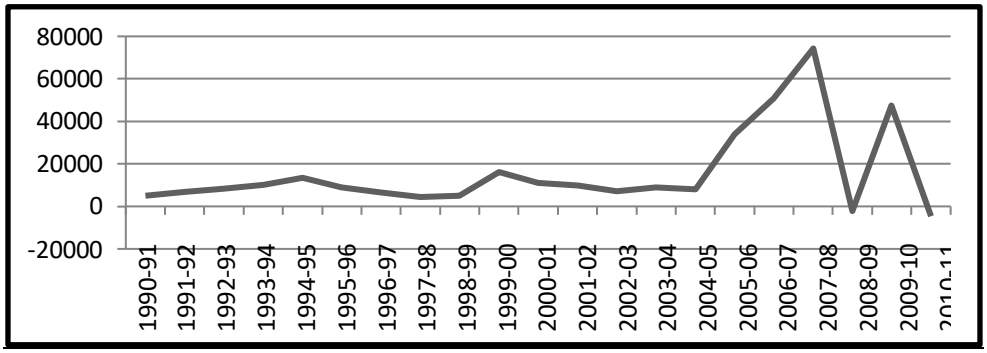
(d) The pattern of Provident and Pension fund investment of India from 1990-2011.



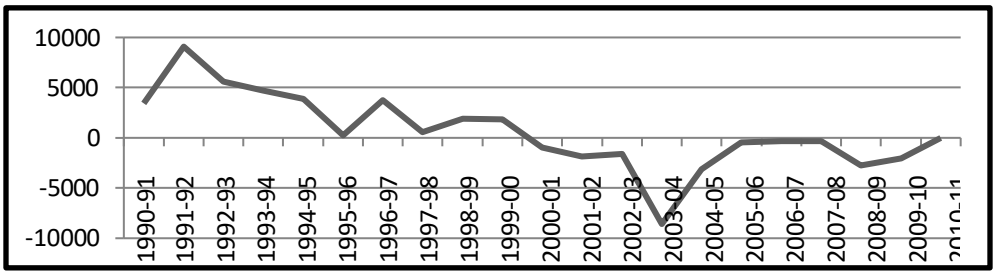
(e) **The pattern of Claims on Government investment of India from 1990-2011.**



(f) The pattern of Shares and Debentures investment of India from 1990-2011.



(g) The pattern of Units of UTI investment of India from 1990-2011.



Net capital formation means increase in the investment of primary market which enhances production capacity of economy further creating employment avenues for the nation. So it has a multiplier effect on Economic Growth and Development of a nation.

The table 2 and chart 2 shown on the next page clearly indicates that over the period of time savings are increasing and the investment of these saving is also increasing which ultimately lead to increase in the rate of Net capital Formation

The savings are increasing at the compounded annual growth rate (CAGR) of 14.11% along with increase of investment at the compounded annual growth rate (CAGR) of 14.225% and the Net

capital Formation which is the result of investment of these saving is also increasing at the compounded annual growth rate (CAGR) of 17.116% over the period of 20 years.

Table 2

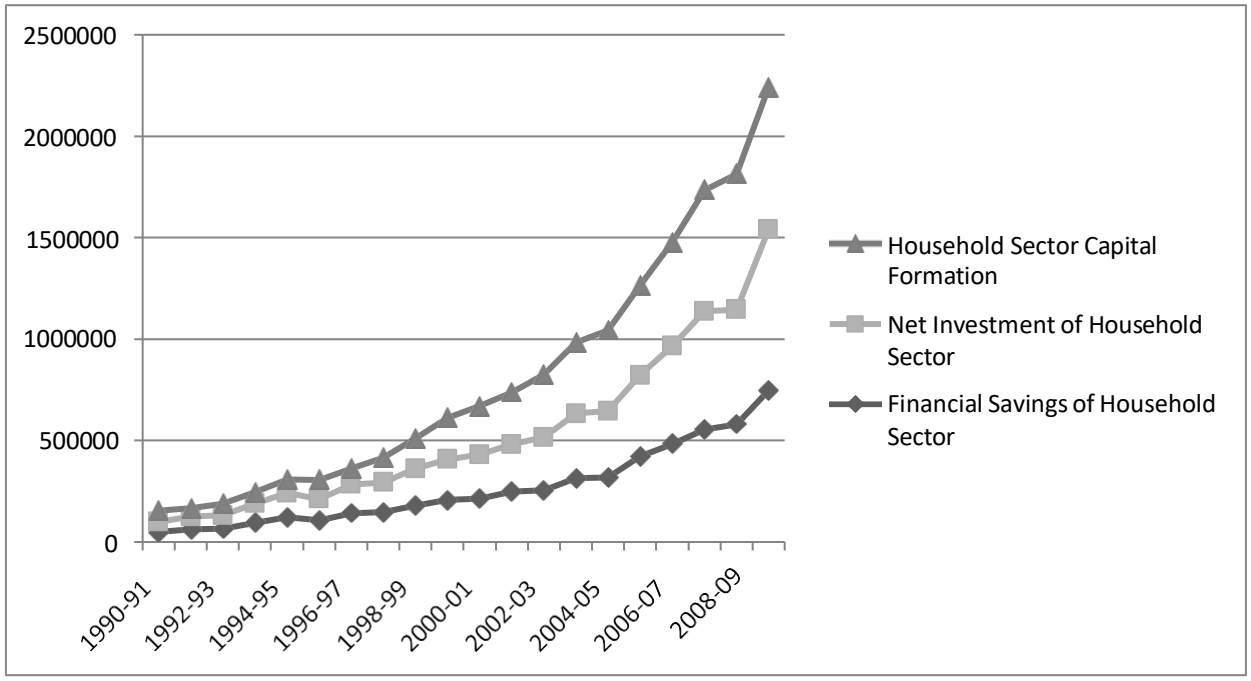
Table Showing the Trend Of Increase In Savings, Investment And Net Capital Formation.

Year	Financial Savings of Household Sector	Net Investment of Household Sector	Household Sector Capital Formation
1990-91	49640	49641	55149
1991-92	62101	62048	41394
1992-93	65367	65298	57948
1993-94	94738	94759	54796
1994-95	120733	120731	68057
1995-96	105719	105717	95296
1996-97	141661	141662	79312
1997-98	146777	146821	122531
1998-99	180346	180330	149414
1999-00	206602	200146	205914
2000-01	215219	215696	239634
2001-02	247476	234307	256689
2002-03	253255	263098	309985
2003-04	313260	319491	350804
2004-05	317546	327096	399328
2005-06	420974	400442	443679
2006-07	482822	482065	512076
2007-08	553289	584204	596846
2008-09	581091	563291	669833
2009-10	747037	793363	700674

Source - Compiled from http://www.rbi.org.in

Chart 2

Chart Showing the Trend Of Increase Of Savings, Investment And Net Capital Formation



Conclusion

Financial services are fundamental to economic growth and development. Banking, insurance, debt and equity financing help public save money, guard against uncertainty and build credit while enabling business to start up, expand, increase efficiency and compete in local and international markets. For the poor, these services reduce vulnerability and enable people to manage the assets available to them in ways that generate income and options ultimately creating paths out of poverty.

Countries with well developed, liberalized, competitive, complementary and well supervised and regulated financial systems tend to create better opportunities for generating faster growth.

The level of banking development, stock market liquidity and intermediation ach exerts a positive influence on economic development.

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