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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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Financial Structures and Economic Development in India

The Reserve Bank today placed on its website a Working Paper titled "Financial Structures and Economic Development in India: An Empirical Evaluation" under the RBI Working Paper Series. The paper has been authored by Dr. Satyananda Sahoo.

While the role of the financial structures in economic development is not a new theme in the economics literature, the recent global financial crisis has posed renewed concerns. An assessment of various indicators of financial development in India reveals that both the bank-based and market-based intermediation processes have undergone remarkable improvement in the last six decades. Financial sector reforms have altered the organisational structure, ownership pattern and domain of operations of institutions and infused competition in the financial sector. This has forced financial institutions to reposition themselves in order to survive and grow. Extensive progress in technology has enabled markets to graduate from outdated systems to modern business processes, bringing about a significant reduction in the speed of execution of trades and in transaction costs. However, there is barely any study that makes a clear comparison between the bank-based and market-based financial system in India.

In this context, this paper makes an attempt to revisit the role of financial structures in economic development of India. The paper argues that the financial sector in India can play a critical role in channeling resources among various sectors - either in a supply-leading or demand-following sequence or both - so as to maximize and broad-base the economic development of India.

Major findings of the paper are:

- While credit disbursement by Indian banks has increased sharply in the past decades, it is still far below the world average level and even below the level in its emerging market and developing economies peers. In recent years, the market capitalization of Indian stock market has increased sharply reflecting more reliance on market-based sources of funding.
- One-way Granger causality running from private sector credit to real GDP confirms the supply-leading process of bank intermediation.
- The autoregressive distributed lag (ARDL) cointegration test, however, suggests that both the bank-based and market-based financial deepening have positive roles in driving India's economic development, while the bank-based system has a stronger impact.
- In a relatively bank-centric financial sector, Indian banks have the potential of further channelization of credit to the productive sectors of the economy. Therefore, Indian Banks need to develop strong linkages with the real sector to develop the ability to maintain high growth levels over a sustained period of time.

Note: The Reserve Bank of India introduced the RBI Working Papers series in March 2011. These papers present research in progress of the staff members of RBI and are disseminated to elicit comments and further debate. The views expressed in these papers are those of authors and not that of the Reserve Bank of India. Comments and observations may kindly be forwarded to authors. Citation and use of such papers should take into account its provisional character.

Sangeeta Das
Director

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