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Research Paper

THE CONUNDRUM OF THE INDIAN FINANCIAL MARKET MULTIPLER POLICY PRESCRIPTION TO KICK START THE CORPORATE DEBT MARKET IN INDIA

BHARATHI. M
Research Scholar
M.Phil Economics
Bharath Institute Of Higher Education And Research
Mail Id : bharathichss@gmail.com

Dr. M. KAVITHA
Assistant Professor, Department Of Economics
Bharath Institute Of Higher Education And Research

Address for Correspondence:
BHARATHI. M
Research Scholar
M.Phil Economics
Bharath Institute Of Higher Education And Research
Mail Id : bharathichss@gmail.com

Abstract

Monetary transmission is the process through which policy changes are converted into the final goals of inflation and growth, after going through certain intermediate steps. The literature has traditionally recognised four main routes of monetary policy transmission: I money or interest rate channel; (ii) credit or balance sheet channel; (iii) exchange rate channel; and (iv) asset price channel. A fifth channel, the expectations channel, has gained importance in the conduct of forward-looking monetary policy in recent years.Interestingly, monetary transmission channels are often referred to as a "black box," meaning that we know monetary policy affects production and inflation, but we don't know how exactly it does so. This is because various monetary transmission channels not only function at the same time, but also vary with time.According to Bernanke and Gertler (1995), empirical research of the impacts of monetary policy has regarded the monetary transmission mechanism as a "black box" to a significant degree. As a consequence, the issue of whether monetary policy has an impact on the actual economy remains unanswered. If yes, what is the method through which these effects are transmitted? Changes in

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monetary policy have different degrees of impact on market interest rates, such as bank lending and bank deposit rates, throughout time.

Introduction

The monetary policy framework, the structure and depth of the financial system in which the central bank works, and the health of the actual economy are all factors that influence the transmission mechanism. While there is a large empirical literature on monetary policy transmission in advanced economies, there are just a few empirical studies on monetary transmission in emerging markets and developing countries (EMDEs). Given the undeveloped nature of financial markets and the fast structural changes in EMDEs, this is reasonable. However, owing to structural and economic reforms and subsequent transitions to market-oriented policy regimes, research of monetary transmission mechanisms in EMDEs, including India, has acquired importance during the 2000s. In India, the literature on monetary transmission is still in its infancy.

An evaluation of how monetary policy changes propagate via financial markets and subsequently the wider economy is required for successful monetary policy implementation. In general, monetary policy is communicated in two phases to ultimate inflation and growth goals. In the first stage, policy changes affect financial pricing and quantities, which then spread throughout the financial system. The real economy is influenced in the second stage by financial pricing and quantities, which affect aggregate spending choices of individuals and businesses, and therefore aggregate demand and inflation. However, whether monetary policy measures affect the range of market interest rates depends on a variety of factors, including the stage of development of different financial markets. According to cross-country research, as domestic financial markets develop, monetary policy transmission via financial channels improves.

Evolution of Monetary Framework in India

Following extensive financial sector changes in the 1990s, India's financial markets have grown substantially in depth and breadth. In addition, the gradual liberalisation of interest rates

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aided market discovery of financial instrument pricing. Deregulation of interest rates, the government's auction-based market borrowing programme, the development of short-term money markets through the introduction of money market instruments, and the discontinuation of automatic monetisation by phasing out ad hoc Treasuries were among the measures taken to facilitate price discovery in various segments of financial markets. These changes enabled a transition in the monetary management operational framework from direct instruments to indirect instruments based on interest rates. Despite the fact that financial reforms started in the early 1990s, their effects were not seen until the late 1990s.

FINANCIAL MARKET MULTIPLER POLICY IMPLEMENTATION

By the early 2000s, most EMEs had adopted inflation targeting (IT), which both encouraged but also required FMD, with significant consequences for monetary policy execution. 1 In fact, the IMF (2004) considered adequately established local money and debt markets to be a precondition for IT. The move to IT was part of a larger trend toward more market-based methods to monetary policy implementation.

Interest rates have surpassed money aggregates as operational targets by the mid-2000s (Graph 1). Market-based instruments, such as repos, have become more important to monetary policy implementation, with the market sectors in which they are employed expanding. FMD and policy implementation have continued to support one another since then. The contributions of central banks at this conference demonstrate this. Despite the fact that most EME policy frameworks have not changed much since the mid-2000s, 86 percent of survey respondents think that monetary policy instruments have impacted FMD, and 75 percent believe that FMD has influenced instrument choice. (Annex Table A1).

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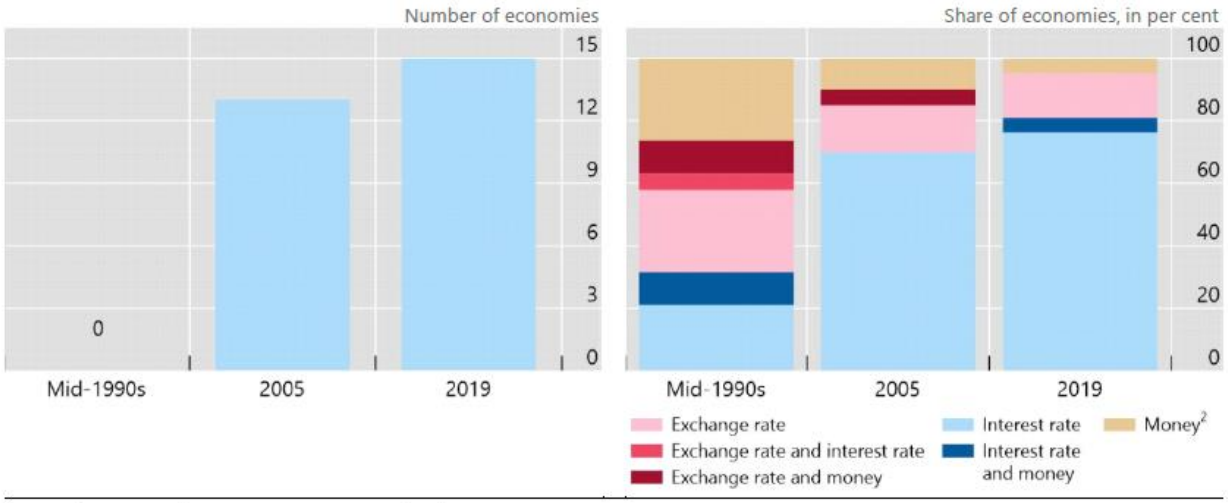
Interest rates have become common operating targets with the introduction of IT Graph 1



[1] Out of 21 EMEs. [2] Monetary aggregate or bank reserve target.

Sources: Archer (2006); Jahan (2015); Markets Committee (2019); BIS calculations.

Many EME central banks have utilised their discretion in selecting monetary tools and objectives to build financial markets during the last two decades. They may do so because different permutations of the central bank's balance sheet can produce any desired policy stance, and because markets utilised in operations grow more liquid, enabling FMD.

Many EMEs have concentrated on growing their money and municipal bond markets. The usage of repos, for example, has encouraged the development of repo markets. The early emergence of the government bond market has been exploited to assist banks' liquidity management via increased use of repo, usually against government paper. As a result, the use of repo has aided government bond secondary market liquidity. Central banks have issued central bank securities to develop the yield curve in areas where local government bond markets were limited compared to liquidity absorption requirements (Annex Table A2). Issuing has been limited to short maturities, mainly to prevent potential conflicts with the Treasury's government bond issuance (Annex Table A3).

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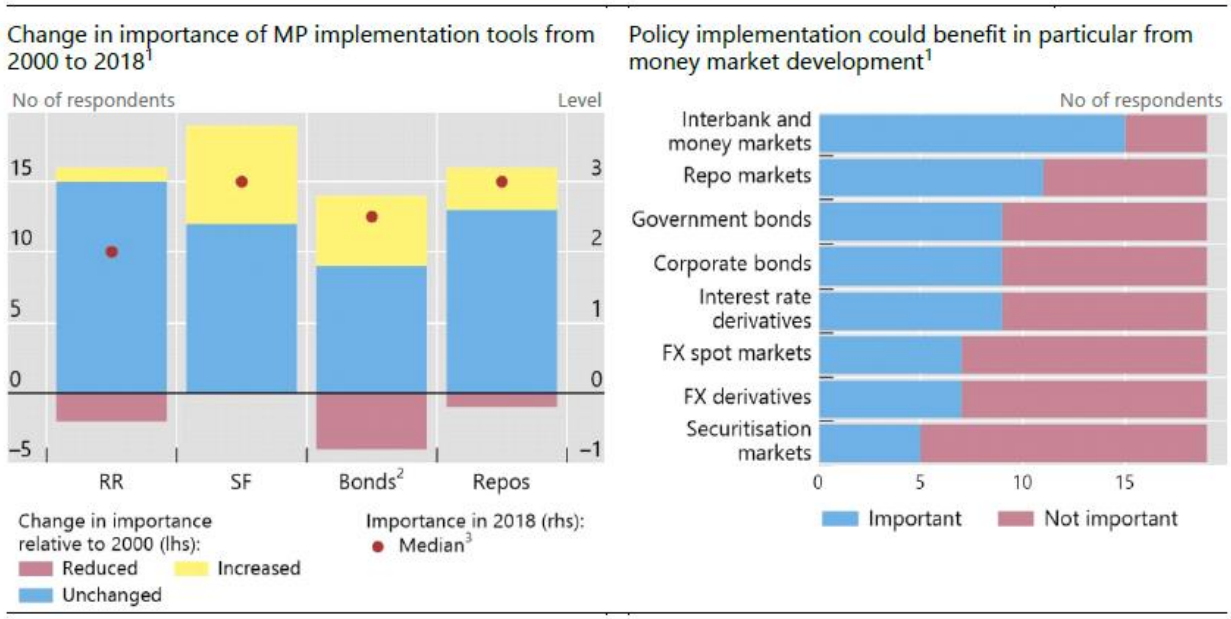
A few EMEs have also used monetary policies in order to create new markets. For example, Hungary's central bank encouraged the issue of mortgage bonds in 2018 as part of its mortgage bond purchase programme to assist banks manage duration risk. As part of a variety of initiatives to encourage banks to participate in green financing, the People's Bank of China has begun to accept green credit and green bonds as acceptable collateral for its monetary policy operations.

Continued FMD could further strengthen policy implementation — Graph 2



SF = Standing facility in domestic currency; RR = Reserve requirements.

[1] Based on survey answers of 19 respondents. [2] Issuance of central bank bonds or government bonds for monetary purposes. [3] High = 3, Low = 0.

Sources: BIS survey; BIS calculations.

Having nurtured a market, sustained FMD may require central banks to reduce their engagement. For example, the Bank of Thailand reports that a private repo market only developed once it ceased to intermediate all repos and instead entered into repos only with primary dealers. Over the past two decades, some EME central banks have continued adjusting their operating targets to take account of FMD. Adjustments have included, for example, a move towards market segments where liquidity had increased, or an adjustment of the targeted maturity. Targets with shorter maturities are easier to control but, at the same time, require

sufficiently developed markets to ensure a stable transmission to the private sector's key funding rates. As an example, the existence of deep repo markets has allowed Mexico to target collateralised rates.

DETERMINANTS OF FINANCIAL INCLUSION IN INDIA

Indian economy has changed a lot over the past 60 years. Over the next 40 years the changes could be dramatic. Using the latest demographic projection and a model of capital accumulation and productivity growth, we map out GDP growth in the Indian economy until 2050. The result shows that if things go right, the Indian economy could become an important source of growth to the world economy. Our projections are optimistic, in the sense that they assume reasonably successful development Any kind of long term projection is subject to a great deal of uncertainty, and we need to be mindful that India's growth transition is unlikely to be smooth or devoid of shocks.

Households in developing countries such as India require finance for a variety of reasons, consumption, and meeting lump-sum expenses like a marriage or illness and most importantly for income-generating activities. Since credit is essential for meeting critical needs, an access to credit is crucial for maintaining and improving social and economic condition of households. Therefore, adequate credit at reasonable cost is important for socio-economic development. So, a well settled and even distributed banking sector is the first need for the purpose of financial inclusion as only formal agencies of credit are able to fulfill both condition i.e., to meet the need of demand of credit for households at an adequate level and at low cost. Many studies argue that 'access to safe, easy and affordable credit and other financial services by the poor and vulnerable groups, disadvantaged areas and lagging sectors are recognized as a pre condition for accelerating growth and reducing income disparities and poverty'.

According to United Nation 'Access to a well-functioning financial system, by creating equal opportunities, enables economically and socially excluded people to integrate better into the economy and actively contribute to development and protect themselves against economic shocks'. Despite the broad international consensus regarding the importance of access to finance

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as a crucial poverty alleviation tool, it is estimated that globally over two billion people are currently excluded from access to financial services (United Nations, 2006a). In most developing countries, a large segment of society, particularly low-income people, has very little access to financial services, M both formal and semi-formal. As a consequence, many of them have to necessarily depend either on their own or informal sources of finance and generally at an unreasonably high cost. The situation is worse in most least developed countries (LDCs), where more than 90 per cent of the population is excluded from access to the formal financial system (United Nations, 2006a).

On the basis of the given review of literature, the researcher identified four parameters to analyse impact of Financial Inclusions, namely; Bank Branches, Credit Account, Savings Account, and Credit-Deposit Ratio.

Through this chapter researcher discusses the relationship between financial inclusion and development with the help of index of financial inclusion and the chapter also explores the factors associated with financial inclusion with the help of Regression Analysis. For this purpose, 15 Indian States were selected out of 28 states, and 6 Union Territories.

Dimension of Index of Financial Inclusion

1. **Accessibility**: Accessibility has been measured by the penetration of the banking system given by the number of bank A/C, per 1,000 populations.

2. **Availability**: Availability has been measured by the number of bank branches and number of ATMs per 1, 00,000 people.

3. **Uses:** The volumes of credit plus deposit are related to the GDP.

A dimension index for each of these dimensions has been first computed by the following formula

dij= Aij-mi/Mi-mi……..(1)

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Where:

Aij = Actual value of dimension i and state j, mi = minimum value of dimension i and state j, Mi = maximum value of dimension i and j state.

After calculating and compilation of the above three dimension i.e., penetration, availability and usage, we can represent a state ij by a point (pij, aij, uij) in the three dimensional Cartesian space, such that $0 \leq pij, aij, uij \leq 1$, where pij, aij and uij denote the each dimension indexes for each state ij computed using formula (1).

After calculate the individual dimensions value of each state, we have applied 2nd equation/ formula. The 2nd formula is given below:

$$IFI = \sqrt{(1-pi) + (1-a1) + (1-ui)/3} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2)$$

The IFI for the state ij is measured by the normalized inverse Euclidean distance of the point (pij, aij, uij) from the ideal point (1). The normalization is done in order to make the value lie between 0 and 1 and the inverse distance is considered so that higher value of the IFI corresponds to higher financial inclusion.

Categorize among of Results on the base of IFI

On the basis of IFI value, all considered states have been categorized into three categories i.e.,

1. $0.5 < IFI \leq 1$ – high financial inclusion

2. $0.3 \leq IFI < 0.5$ – medium financial inclusion

3. $0 \leq IFI < 0.3$ – low financial inclusion

Multiple Regression Equation Model

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Multiple regressions represent a logical extension of more than two variables regression analysis. Instead, more than one independent and one dependent variable is used to estimate the values of a dependent variables. The multiple regression equation describes the averages relationship among more than two variables and this relationship is used to predict or control the dependent variables. The formula for calculating multiple regressions is as follow:

The general form of the regression equation is:

$Y = a_0 + a_1X_1 + a_2X_2 + \ldots a_nX_n + \varepsilon$ ……………………… (3)

Where X_1, X_2 etc are regressed variables, a_1, a_2 and so on are the parameters to be estimated from the data and ε is the error term following classical OLS assumptions i.e., The deviations ε is assumed to be independent and normally distributed with mean 0 and standard deviation (σ).

In the regression equations, the dependent variable is a logit transformation of the index of financial inclusion described earlier. Unlike the IFI which lies between 0 and 1, the transformed variable lies between -∞ and ∞. This allows us to carry out the classical OLS regression. The transformed variable is a monotonically increasing function of IFI, and hence it preserves the same ordering as IFI. The transformed variable is a logit function of the original variable IFI, as defined below.

Y = IFI (IFI/1- IFI)…………………………………….. (4)

In this paper, we have framed four regression equations i.e., the first regression measure the degree of relation between development and financial inclusion, second equation measures the degree of relation between economic development and financial inclusion, third describes the relation between economic development indicator and financial inclusion and the last highlights the relation between socio economic development and financial inclusion.

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The empirical model variables, their proxies, and the predicted coefficient sign are summarized in box-1.

Figure 3.1

Empirical Models Variables

Variables	Proxy	Predicated Coefficient Sign
Model-1		
Development	HDI: Dependent	
IFI	Independent	+
Model-2		
Economic Development	Per Capita Value of NSDP: Dependent	
IFI	Independent	+
Model-3		
Factor Associated to Financial Inclusion		
Financial Inclusion	IFI	
Economic- Development Factors/Variables	Per Capita Value of NSDP	+
	Employment Rate	+
Social-Development Factors/Variables	Literacy Rate	+
	Urbanization	+
	Sex-Ratio	+

Thus, the empirical models of the study have been given below:

$HDI = a_0 + a_1IFIX_1 + \varepsilon$ ……...……..... (5) $PCNSDP = a_0 + a_1IFIX_1 + \varepsilon$……...…... (6)

$IFI = a_0 + a_1PCNSDPX_1 + a_2ERX_2 + \varepsilon$ ……..... (7)

$IFI = a_0 + a_1LRX_1 + a_2URBX_2 + SRX3 + \varepsilon$ ……..... (8)

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All variables are used in natural logarithm form for economic estimation. Because Ehrlich (1977) and Layson (1983) argue on theoretical and empirical grounds that the log linear form is superior to the linear form. Both Cameron (1994) and Ehrlich (1996) suggest that a long-linear form is more likely to find evidence of a restraints effect than a linear form.

Thus, the final empirical models of the study are

$$\text{In (HDI)} = a_0 + a_1 \text{In (IFIX}_1) + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots (5)$$

$$\text{In (PCNSDP)} = a_0 + a_1 \text{In (IFIX}_1) + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots (6)$$

$$\text{In (IFI)} = a_0 + a_1 \text{In (PCNSDPX}_1) + a_2 \text{In (ERX}_2) + \varepsilon \ldots\ldots\ldots\ldots\ldots\ldots (7)$$

$$\text{In (IFI)} = a_0 + a_1 \text{In (LRX}_1) + a_2 \text{In (URBX}_2) + \text{In (SRX3)} + \varepsilon \ldots\ldots\ldots (8)$$

Table 3.1

Index of Financial Inclusion and Human Development Index, 2001

State/Union Territory	Index of Financial Inclusion (IFI)		Human Index Value (HDI)	
	Value	State Rank	Value	State Rank
Andhra Pradesh	0.316	8	0.416	10
Assam	0.023	15	0.386	14
Bihar	0.083	14	0.367	15
Gujarat	0.420	6	0.479	6
Haryana	0.402	7	0.509	5
Karnataka	0.562	3	0.478	7
Kerala	0.753	2	0.638	1
Madhya Pradesh	0.128	13	0.394	12
Maharashtra	0.465	5	0.523	4
Orissa	0.159	12	0.404	11
Punjab	0.754	1	0.537	2
Rajasthan	0.181	10	0.424	9
Tamil Nadu	0.522	4	0.531	3
Uttar Pradesh	0.165	11	0.388	13
West Bengal	0.244	9	0.472	8

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Source: Planning Commission (2002), National Human Development Report, 2001, March, Table, A-13

Note: Rest of the Indian States have not been considered due to lack of necessary Data.

Table 3.1 presents the IFI computed for 15 states and the corresponding human development index (HDI) value along with their ranks (According to census, 2001). Punjab, with an IFI value of 0.75 leads the list, while, Assam with an IFI value of 0.2 ranks the lowest among all states. The table further reveals the combine trend of the IFI and HDI. The IFI and HDI seem too moved in the same direction. The IFI and HDI for the set of 15 states move closely with each other and the value of coefficient of variance in financial inclusion index is high i.e., 67.24 per cent as compare to the coefficient of variance in HDI of different states of India. The correlation of coefficient between IFI and HDI and ranks is found to be about 0.911, and is highly significant at1 per cent level of significance (see table-3.2).

Figure 3.2

Association between Financial Inclusion and Development

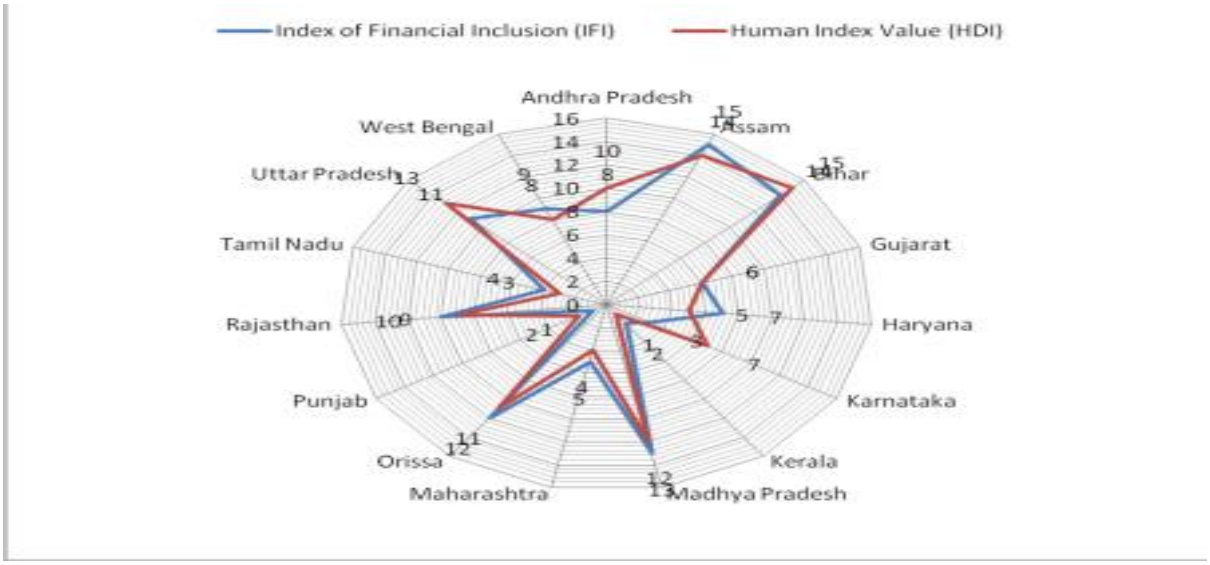

Table 3.2

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Correlation Matrix between IFI and HDI

Variables	Mean	S.D.	IFI	HDI
IFI	0.345	0.232	1	
HDI	0.463	0.075	.911**	1

Note: No. of Observations is 15 and Coefficient of Correlation is Significant at the 0.01 level (1-tailed)

Table 3.3

Result of Regressing IFI on Development

Results	Coefficient	Std. Err.	t	p> [t]
Constant	.361	.015	23.648	.000
IFI	.295	.037	.037	.000
Multiple R	.911			
R^2	.830			
Adj. R^2	.817			
F (1,13)	63.370			.000

Note: No. of Observations is 15, Dependent Variable, HDIV

It is evident from table 3.3 that the, index of financial inclusion (IFI) is highly positively and statistically significantly related to the development (HDI). Therefore, the null hypothesis 'Financial inclusion is positively and significant related to overall development' has been accepted and further is according to United Nation 'Access to a well-functioning financial system, by creating equal opportunities, enables economically and socially excluded people to integrate better into the economy and actively contribute to development and protect themselves against economic shocks'. Thus, we can say that financial inclusion and development are interlinked.

Table 3.4

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Correlation Matrix between IFI and Per Capita NSDP

Variables	Mean	S.D.	IFI	HDI
IFI	0.345	0.232	1	
Per Capita NSDP	16744.60	6085.01	.816*	1

Note: No. of Observations is 15 and Coefficient of Correlation is Significant at the 0.01 level (2-tailed)

Table 3.5

Result of Regressing IFI on Economic Development

Results	Coefficient	Std. Erròr	t	p> [t]
Constant	19862.245	1235.832	16.072	.000
IFI	8246.300	1839.037	4.484	.001
Multiple R	.779			
R^2	.607			
Adj. R^2	.577			
F (1,13)	20.107			.001

Note: No. of Observations is 15, Dependent Variable, Per Capita NSDP

Table 3.4 expresses the coefficient of correlation between IFI and per capita NSDP along with the mean and S.D. value of the individual variables. The coefficient of correlation between same variables is positively and significantly associated (at 0.01 per cent level of significant).

Table 3.5 exhibits that the per capita NSDP is significantly influenced by financial inclusion. The regression coefficient of IFI is significant. Therefore, the null hypothesis 'financial inclusion is significantly affected the per capita NSDP or economic development' is accepted. The value of R^2 is .607 or 60.7 per cent. It means 60.7 per cent variation in per capita is occurring due to financial inclusion. Finally, the regression equation is fit; because, the value of 'F' statistics is significant at 0.01 level of significance.

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Major Findings of the study

1. The rank of Punjab is 1st in financial inclusion with the value of 0.754 while, in HDI, the value of Punjab is 2nd. Assam, stood at last position in financial inclusion index, and in the 14th in HDI (Census: 2001)

2. The rank of financial inclusion and the rank of human development index both are very closely moved. It means, financial inclusion and HDI both are very closely related. The coefficient of correlation between financial inclusion and HDI is 0.911 and it is significant at 0.01 per cent level.

3. The financial inclusion and per capita NSDP both are also positively related to each other and statically and the value of coefficient of correlation between same variables is .816 and it is significant at 0.01 per cent level.

4. The financial inclusion index and the coefficient of sex-ratio, literacy rate, and employment rate are positively correlated but, these coefficients are not significant to financial inclusion.

5. According to index of financial inclusion only four states are having very high financial inclusion i.e., Punjab, Tamil Nadu, Kerala and Karnataka, four lie between moderate financial inclusion i.e., Haryana, Gujarat, Andhra Pradesh and Maharashtra and seven states i.e., Assam, Bihar, MP, Orissa, Rajasthan, UP and WB exist in low level of financial inclusion (out of 22 states of India).

6. No significant disparity of financial inclusion is found among selected states of India. But, the range (L-S) of financial inclusion index value is very high and stood at 0.731 in 2001.

7. Per capita NSDP predicts the 59.0 per cent variance in financial inclusion. 8. Literacy Rate, Urbanization and Sex-Ratio, do not jointly predict the variance in financial inclusion, but according to this model, individually, urbanization is significant explores/predicts the variation

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in financial inclusion. Overall regression (equation-4) explored/predict the 55.4 per cent variation in financial inclusion.

After analyzing the data researcher found that the IFI/FI is positively and significantly associated with the socio- economic development. Further, researcher also found that per capita NSDP and urbanization significantly explore the financial inclusion while, literacy, employment and sex ratio are not significant explore/ predictors of the financial inclusion. On the basis of foregoing analysis the researcher suggests that the government should ensure the easy availability of finance at low cost and reasonable time.

CONCLUSION

Several challenges are being faced in implementation of financial inclusion policies. More and more innovative products will have to be introduced for benefiting both the banks. Business Correspondent (BC) model is more viable in this situation. Today, there are 1,88,028 villages in India (out of 6,00,000) connected with the mainstream banking system, over 147 million basic banking accounts (previously known as No Frills accounts) have been opened and more than 74,000 habitations with a population of over 2,000 are connected with formal financial system. Business Correspondents‟ have played a key role in making this possible. The target market is very price sensitive as Business Correspondents largely target low-income customers with irregular cash flows. However, the pricing varies from one bank to another, so some banks charge an account opening fees for Basic Savings Bank Deposit Accounts (Basic Savings Accounts) while others do not. As a result, in a given village, a Business Correspondents from one bank may charge a Basic Savings Bank Deposit Accounts opening fee and another bank‟s Business Correspondents may not. Similarly, the fee per transaction (withdrawal or deposit), differs between banks. A person, acting as Business Correspondents for multiple banks believes that accounts with no account opening charges will demonstrate higher usage and less dormancy as compared to accounts with charges. Hence, this lack of a uniform pricing strategy among banks adversely impacts uptake and contributes to dormant accounts. Of 2,68,000 banking

outlets nearly 2,21,000 are Business Correspondents i.e. nearly 82 percent. Sustainability and scalability of the Business Correspondent model is essential. To ensure increased banking penetration and control over operations of Business Correspondents, banks have been advised to establish low cost branches in the form of intermediate brick and mortar structures in rural centers between the present base branch and locations of Business Correspondents, so as to provide support to a cluster of Business Correspondents (about 8–10 BCs) at reasonable distance of about 3-4 kilometers. Business Correspondents‟ should not be limited to serving just the rural poor. To make them economically viable and sustainable they should serve the rich and the poor globally. Business Correspondents should be large non-profit entities that strive to attract top quality talent. They should be well managed to provide distribution, financial literacy, customer service and demand aggregation to multiple service. Since that watershed regulation was introduced, the Reserve Bank of India says there are 221,341 "Business Correspondents" or Customer Service Points employed by banks to help get services to people at the bottom of the income pyramid. Allow Business Correspondents to charge their customers a fee in exchange for membership "perks" (lower cost of daily goods) model. To make a financial revolution Possible we need to make more and more transactions electronic (because the cost of an electronic transaction at scale is close to zero) and reduce the cost of a cash transaction to Rs.2/- to Rs.3/-. We also need to operate in a paper less, card less and leverage existing infrastructure while raising a large deposit pool to meet the credit needs of the unbanked.

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