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Principal Investigator	Co-Principal Investigator	Co-Principal Investigator	Co- Principal Investigator (Technical)
Prof H C Pokhriyal Professor and Executive Director, School of Open Learning University of Delhi	**Dr Jaswinder Singh** Principal SGTB Khalsa College University of Delhi	**Dr Jatinder Bir Singh** Principal SGGS College of Commerce University of Delhi	**Dr Vimal Rarh** Assistant Professor, Department of Chemistry, SGTB Khalsa College, University of Delhi *Specialised in : e-Learning and Educational Technologies*

Paper Coordinator	Authors	Reviewer
Dr. Manisha Vats Associate Professor Miranda House University of Delhi Delhi-110007	**Ms. Pragya Nayyar** Assistant Professor, SGTB Khalsa College University of Delhi	**Dr. Satish Verma** Professor, RBI Chair Centre For Research in Rural And Industrial Development Chandigarh-160 019

Anchor Institute : SGTB Khalsa College, University of Delhi

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1. Learning Outcomes

After studying this module, you shall be able to

- Know the concept of Financial Markets. Understand the use of financial assets and classify different types of Financial Markets: Money market and Capital Market
- Analyze the working of innovative global financial markets.

2. Financial Assets

In a market economy the allocation of economic resources is the result of many private decisions. Prices are the signals operating in the market economy that direct economic resources to their best use. The types of markets in any economy can be divided into:

1. The market for products or the *product market*
2. The market for factors of production or the *factor market.*

The market for factors is also the market for financial products or simply the Financial Market.

To know the concept of Financial Markets it is important to understand the meaning of a financial asset.

Financial Assets: Definition

An asset is any possession that has value in an exchange. It can be categorized as tangible or intangible. Tangible asset are those whose value depends on specific physical properties. Eg: buildings, land or machinery. Intangible assets represent legal claims to some future benefit. Financial Assets are under the intangible assets for which the value is the claim to future cash. The entity that agrees to pay future cash is the issuer of the financial asset and the owner of the financial asset is the investor.

Role of Financial Asset

The first is to transfer funds from those having surplus funds to one who needs funds to invest in tangible assets. The other function is to transfer funds in such a manner as to reallocate the unavoidable risk linked with the cash flow generated by tangible assets among those seeking & those providing the funds.

3. Financial Markets

Definition:

A Financial Market is a market where financial assets are traded or exchanged. While the presence of a financial market is not an essential condition for the creation & exchange of a financial asset, in most economies financial assets are created and then traded in some type of financial market. Example: A spot or cash market is one in which a financial asset trades for immediate delivery.

Role of Financial Markets

Financial markets deliver the following 3 additional economic functions:

1. The interaction of buyers & sellers in financial market determine the price of the traded asset or equivalently, they determine the required return on a financial asset. As the inducement for firms to obtain funds relies on the required return that investors demand, it is this characteristic of financial markets that indicates how the funds in the economy should be distributed between various financial assets. This is termed the *price discovery process*.

2. These markets offer a procedure to an investor to sell a financial asset. Because of this characteristic, it is believed that a financial market renders *liquidity*, an striking feature when circumstances either force or encourage an investor to sell. If there was no liquidity, the owner would be forced to hold a debt instrument until it matures and equity instrument until the company is either voluntarily or involuntarily liquidated.

3. Financial markets on economic front reduce the cost of transaction. There are 2 costs associated with transacting: *Search cost and Information cost*

   - Search costs represent explicit cost, such as money spent to advertise ones intention to sell or purchase a financial asset, and implicit cost, such as the value of time spent in locating a counter party. The existence of some form of organized financial markets reduces search costs.

   - Information costs are costs linked with assessing the investment merits of a financial asset, i.e., the amount and the likelihood of cash flow expected to be generated. In an efficient market, prices reflect the aggregate information collected by all market participants.

In a nutshell, financial markets help solve the issues with pricing of financial assets and risk associated with the expected cash flow from a financial asset.

The working of the above functions of financial markets can be best understood through several types of financial markets. There are many ways to categorize financial markets. One of the way is by the type of financial claim, such as debt markets and equity markets. Another is by the maturity of the claim. For example, there is a financial market for short term debt instruments, called the money market and one for longer maturity financial assets, called the capital market.

3. Classification of Financial Markets

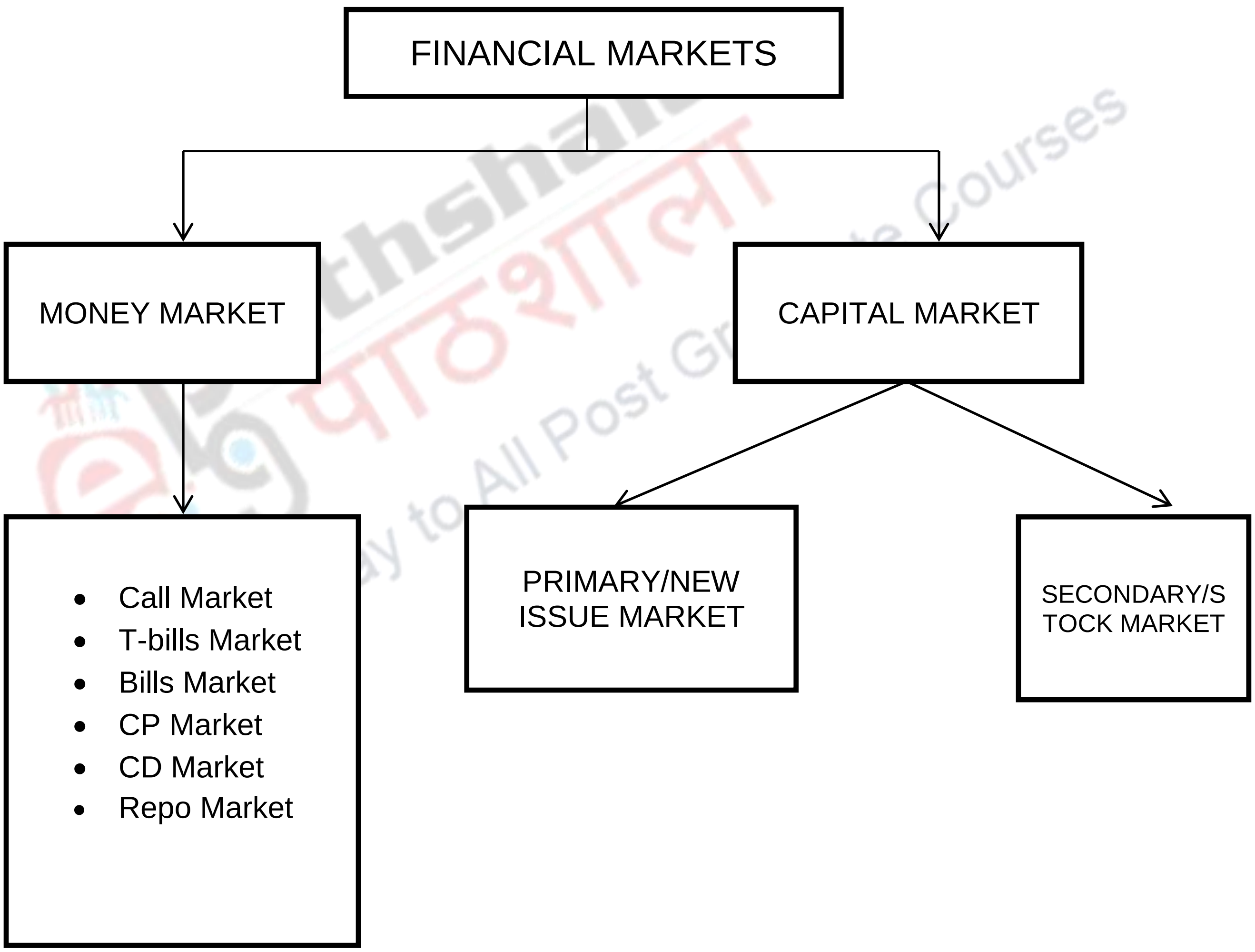

Figure 1: Financial markets

The classification of Financial Markets based on Term to maturity:

3.1 Money Markets

Money market is a market for dealing in monetary assets of short-term nature, generally less than one year. It refers to that segment of the financial market which allows the raising up of short term funds for fulfilling temporary shortages of cash & obligations and the temporary deployment of excess funds for earning returns.

Major Participants

1. **RBI-Reserve Bank of India**
   It is India's central banking institution that controls the monetary policy of the Indian rupee. It was established on 1 April 1935 during the British Raj in accordance with the provisions of the Reserve Bank of India Act, 1934.

2. **Commercial Banks**
   It is a type of bank that offers services like accepting deposits, making business loans, & offering basic investment products. E.g. SBI, Indian Overseas bank.

Broad Objectives of Money Market

1. An equilibrating mechanism for evening out short term surpluses and deficiencies.
2. A focal point of RBI (central bank) intervention for influencing liquidity in the economy.
3. Access to the users of short term funds to meet their need at reasonable price and cost.

Features of a developed Money Market

- Presence of central Bank
- Highly organized commercial Banking System
- Presence of sub-markets
- Integrated structure of money market
- Accessibility of proper credit instruments
- Acceptability & elasticity of funds
- International attraction
- Uniformity of interest rates

- Stability of prices
- Highly developed Industrial system

Tools of Money Market as indicated in figure 1

- Certificate of deposit

  A certificate of deposit is a promissory note issued by a bank. It is a time deposit that limits holders from drawing funds on demand. Although it is still possible to withdraw the money, this action will often incur a penalty.

  For example, let's say that you purchase a Rs.10,000 CD with an interest rate of 5% compounded annually and a term of one year. At year's end, the CD will have grown to Rs.10,500 (Rs.10,000 * 1.05).

- Repurchase agreements

  Short-term loans—normally for less than two weeks & regularly for one day—arranged by selling securities to an investor with an agreement to re-purchase them at a fixed price on a fixed date.

- Commercial paper

  Short term usanse promissory notes issued by company at discount to face value & redeemed at face value.

- Treasury bills

  Short-term debt commitments of a national government that are issued to mature in 3-12 months.

- Call Market

  A type of market in which each transaction takes place at predetermined intervals and where all of the bid and ask orders are aggregated and transacted at once. The exchange regulates the market clearing price based on the number of bid & ask orders. A call market is differentiated to an auction market, where orders are filled as soon as a buyer/seller is found for any given order at an agreed upon price.

Importance of Money Market

- Financing Industry
- Financing trade
- Self sufficiency of banks

- Effective implementation of monetary policy
- Encourages economic growth
- Help to government
- Proper distribution of resources

3.2 Capital Markets

It is a market for long term funds. Its focus is on financing of fixed investment in contrast to money market which is the institutional source of working capital finance.

Participants

- **Mutual funds**
  An open-ended fund functioned by an investment company which raises money from shareholders & invests in a group of assets, in accordance with a stated set of objectives.

- **Insurance companies**
  A company that provides insurance policies to the public, either by selling directly to an individual or via another source such as an employee's benefit plan. An insurance company is generally comprised of multiple insurance agents. An insurance company can specialize in one type of insurance, such as life insurance, health insurance, or auto insurance, or offer multiple types of insurance.

- **Foreign institutional investors**
  A hedge fund, pension fund manager, mutual fund, bank, insurance company, large corporate buyer, or a representative agent for any of these parties that is registered to do business in a country other than where the investment instrument is being purchased. The investor takes positions in foreign financial markets on behalf of the institution in the home country.

- **Corporates and individuals**

Financial instruments traded in the capital market

- **Equity instruments**
  An instrument that signifies an ownership position (called equity) in a corporation, & signifies a claim on its proportional share in the corporation's

assets & profits. Ownership in the company is determined by the no. of shares a person owns divided by the total no. of shares outstanding.

E.g., if a company has 1000 shares of stock outstanding & a person owns 50 of them, then he/she owns 5% of the company.

- **Foreign exchange instruments**
  Any financial instrument that locks in a future foreign exchange rate. These can be used by currency or forex traders, as well as large MNC's. The latter frequently uses these products when they presume to receive large sums of money in the future but want to hedge their exposure to currency exchange risk. Financial instruments that are part of this group comprise: currency options contracts, currency swaps, and forward contracts and futures contracts.

- **Hybrid instruments**
  An investment product that merges the attributes of an equity security with a debt security. Generally, these instruments are considered as debt-type instruments with exposure to the equities market. The examples of these instruments are convertible bonds, preferred stocks, equity default swaps & structured notes linked to an equity index.

<u>Nature of capital markets</u>

- It Has 2 segments
- It Transacts in Long-Term Securities
- It Accomplishes Trade-off Function
- It Generates Dispersion in Business Ownership
- It Benefits in Capital Formation
- It Helps in creating Liquidity

<u>The two components of capital market are: Primary market and Secondary market</u>

<u>PRIMARY MARKET/ New Issue Market (NIM)</u>

The NIM deals in new securities, that is, securities which were not formerly accessible and are offered to the investors for the first time. Capital formation take place in the NIM as it delivers additional funds to the corporates directly.
It does not have any organisational setup located in any particular place and is recognized only by the specialist institutional services that it tenders to the

lenders/borrowers (buyers/sellers) of capital funds at the time of any particular operation.

It performs triple-service, namely

1. **Origination**, that is, investigation & analysis & processing of new issue proposals.
2. **Underwriting** in terms of guarantee which states that the issue would be sold regardless of public response.
3. **Distribution** of securities to the investors.

Methods for raising capital in primary market

- **Public Issue**
  Issue of stock on a public market rather than being privately funded by the companies own promoter(s), which may not be enough capital for the business to start up, produce, or continue running. By issuing stock publically, this allows the public to own a part of the company, though not be a controlling factor.

- **Private Placement**
  The sale of securities directly to an institutional investor, like a bank, mutual fund, insurance company or foundation. Does not need SEC registration, as long as the securities are bought for investment purposes instead of resale, as stated in the investment letter.

- **Right Issue**
  An issue of rights to a company's existing shareholders which enables them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period.

- **Electronic-Initial Public Offer**
  It is the first sale of stock to the public by a company. Companies proposing an IPO are at times new, young companies, or maybe companies which have been around for many years but have lastly decided to go public. IPOs are often risky investments, but often have the potential for noteworthy gains. IPOs are also used as a way for a young company to gain required market capital.

- **Secondary Stock Market/Exchange (SE)**

The SE is a market for old/existing securities, that is, those already issued and granted SE quotation. It plays only an indirect role in industrial financing by providing liquidity to investments already made. It has a physical existence and is located in a particular geographical area.

Vital Functions Performed by SE are:

- Nexus between savings and investments.
- Liquidity to investors by offering a place of transaction in securities.
- Continuous price formation.

Another type of classification for financial markets is based on the types of assets:

Debt versus Equity

The claim that the holder of a financial asset has may be either a fixed amount or varying/ residual amount. In the earlier case, the financial asset is stated as a Debt instrument while the latter is stated as the equity. For example common stock is equity. Some securities fall into both categories, example preferred stock.

4. Market Participants

Participants in national financial market and global financial markets are different. The national participants as discussed are unique to money and capital market. In a global financial markets, participants that issue and purchase financial claims include households, business entities (corporations and partnerships), national government, national government agencies, state and local governments, and supranationals such as the World bank, the European Investment Bank and the Asian development bank.

5. Globalization of Financial Markets

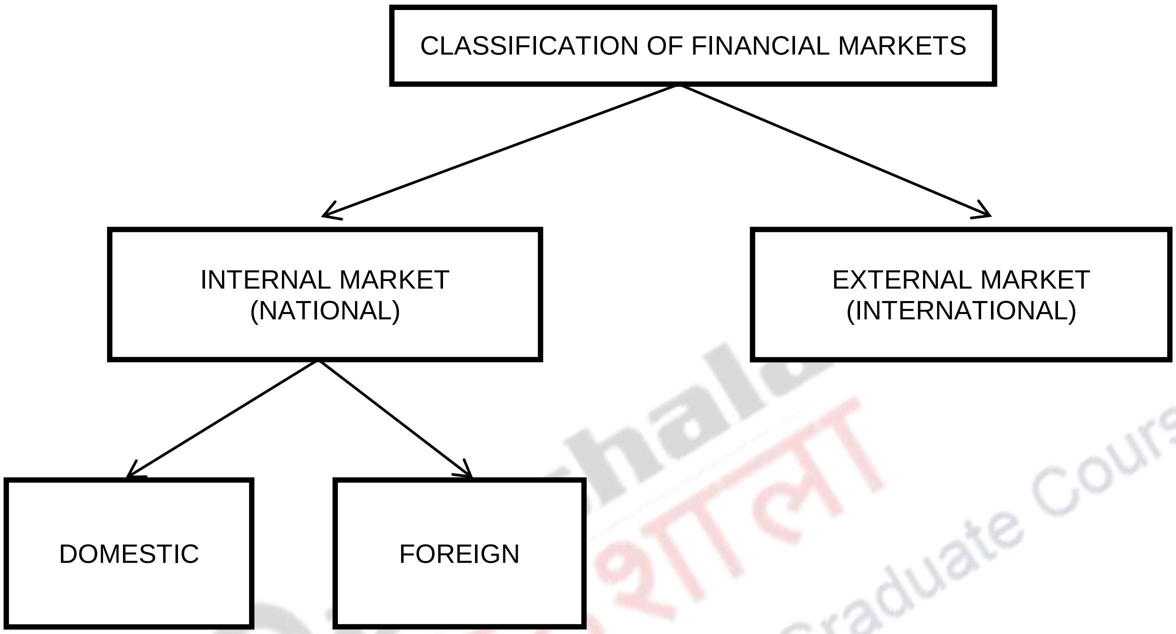

Figure 2: Classification of Financial Markets

From the viewpoint of a given country, financial markets can be classified as

1. Internal/ National market

    - Domestic market

      Where issuers domiciled in a country issue securities & where these securities are consequently traded.

    - Foreign market

      Where securities of issuers not domiciled in the country are sold and traded.

2. External/ International market

   This market permits trading of securities with two different features: first- at issuance securities are offered simultaneously to investors in a number of countries and second- they are issued outside the jurisdiction of a single country. Thus it is denoted as the offshore market or the Euromarket.

6. Summary

A financial asset entitles the owner to future cash flows to be paid by the issuer as well as to the liquidation value of the asset. Financial markets offer the following 3 services: first, the price discovery for financial assets, second liquidity and third reduction in transaction costs of financial markets. There are various ways to categorize financial markets for e.g. money vs. capital market, debt vs. equity markets, primary vs. secondary and cash vs. derivative market. The increased integration of financial markets throughout the world can be credited to 3 factors: First, de-regulation or liberalization of major financial markets, second, advances in telecommunications and computer technologies and third, institutionalization of financial markets. Based on the above factors, global financial markets can be categorized as national and external markets.