UNIT II

FINANCIAL MARKETS - I

4

CHAPTER

INTRODUCTION TO FINANCIAL MARKETS

வாரி பெருக்கி வளம்படுத்து உற்றவை
ஆராய்வான் செய்க வினை.

–குறள் 512

COUPLET

Let him do (the king's) work who can enlarge the sources (of revenue), increase wealth and considerately prevent the accidents (which would destroy it).

Learning Objectives

To enable the students to understand the

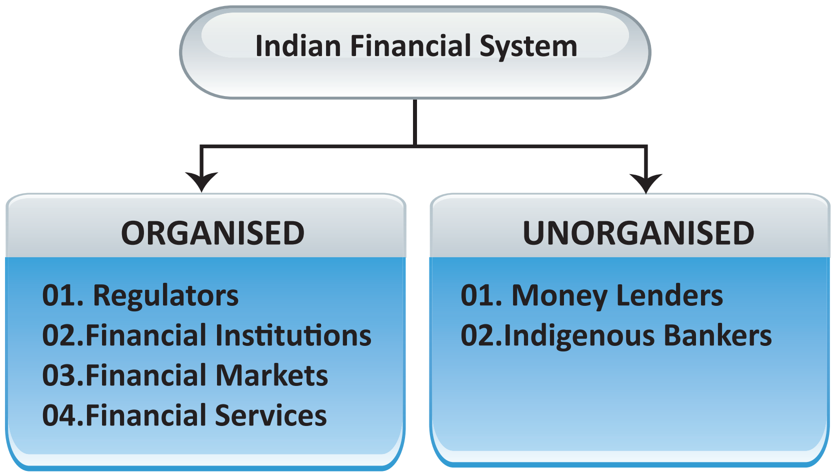
- Meaning and definition of financial market
- Scope of Indian Financial Market
- Types of Financial market
- Role of financial market
- Functions of financial market
- New Issue Market Vs Secondary Market

Chapter Synopsis

4.01 Meaning and Definition of Financial Market
4.02 Scope of Indian Financial Market
4.03 Types of Financial Markets
4.04 Role of Financial Market
4.05 Functions of Financial Market
4.06 New Issue Market (NIM) Vs. Secondary Market

Business firms need large funds to undertake a desired project. Accumulation of these funds may be beyond their capacity in a reasonable period of time. Governments need funds to provide goods and services to the people. Financial market facilitates business firms as well as governments to raise the needed funds by issuing and selling different instruments. Financial market also helps investors to facilitate them to invest surplus funds and earn a return. With the help of financial market, all kinds of business, Government and the financial institutions can get financial assistance in terms of both short term finance and long term finance.

Before going into the details, let us have an understanding of the Indian financial system. The Indian financial system can be broadly classified into organized sector and unorganized sector. Organized sector consist of Regulators, Financial Institutions, Financial Markets and Financial Services. The unorganized sector consists of Money Lenders, Indigenous Bankers etc. The financial system facilitates the flow of funds from

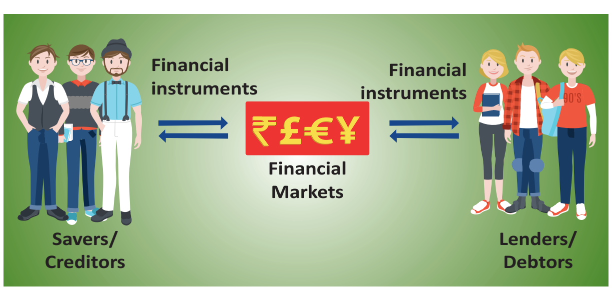


the suppliers to the users. The following diagram explains the Indian Financial System.

4.01 Meaning and Definition of Financial Market

A market wherein financial instruments such as financial claims, assets and securities are traded is known as a 'financial market'.

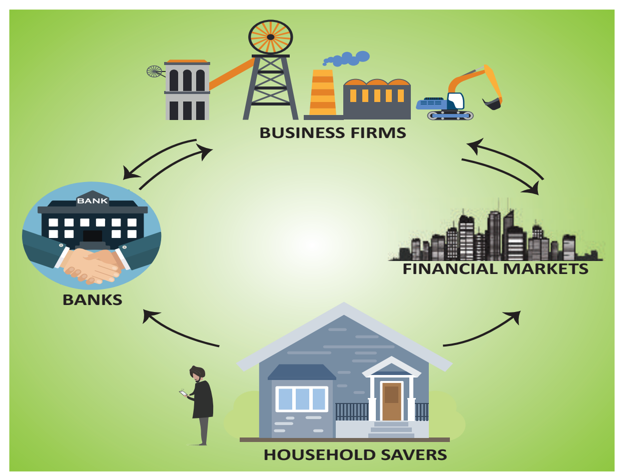
In another words, financial markets may be channels through which flow loanable funds directed from a supplier who has an excess of assets toward a demander who experiences a deficit of funds.



According to Brigham, Eugene F, "The place where people and organizations wanting to borrow money are brought together with those having surplus funds is called a financial market."

A financial market, unlike the other markets, is more of an intangible concept and basically refers to a market place where buyers and sellers usually participate in an exchange of assets such as equities, bonds, derivatives and currencies.

Financial Market is a market for creation and exchange of financial assets from household savers to business firms or financial institutions as in the following picture.



A financial market is an institution or arrangement that facilitates the exchange of financial instruments such as equity shares, preference shares, debentures, deposits and loans, corporate stocks and bonds, government bonds, and more exotic instruments such as options and futures contracts.

Financial market transactions may take place either at a specific place or location, e.g. stock exchange, or through other mechanisms such as telephone, telex, or other electronic media.

4.02 Scope of Indian Financial Market

The financial market provides financial assistance to individuals, agricultural sectors, industrial sectors, service sectors, financial institutions like banks, insurance sectors, provident funds and the government as a whole. With the help of the financial market all the above stated individuals, institutions and the Government can get their required funds in time. Through the financial market the institutions get their short term as well as long term financial assistance. It leads to the overall economic development.

4.03 Types of Financial Markets

Financial Markets can be classified in different ways. They are as follows:

a. On the Basis of Type of Financial Claim

(i) **Debt Market** is the financial market for trading in Debt Instrument (i.e. Government Bonds or Securities, Corporate Debentures or Bonds)

(ii) **Equity Market** is the financial market for trading in Equity Shares of Companies.

b. On the Basis of Maturity of Financial Claim

(i) **Money Market** is the market for short term financial claim (usually one year or less) E.g. Treasury Bills, Commercial Paper, Certificates of Deposit

(ii) **Capital Market** is the market for long term financial claim more than a year E.g. Shares, Debentures

c. On the Basis of Time of Issue of Financial Claim

(i) **Primary Market** is a term used to include all the institutions that are involved in the sale of securities for the first time by the issuers (companies). Here the money from investors goes directly to the issuers.

(ii) **Secondary Market** is the market for securities that are already issued. Stock Exchange is an important institution in the secondary market.

d. On the Basis of Timing of Delivery of Financial Claim

(i) **Cash/Spot Market** is a market where the delivery of the financial instrument and payment of cash occurs immediately. i.e. settlement is completed immediately.

(ii) **Forward or Futures Market** is a market where the delivery of asset and payment of cash takes place at a pre-determined time frame in future.

e. On the Basis of the Organizational Structure of the Financial Market

(i) **Exchange Traded Market** is a centralized organization (stock exchange) with standardized procedures.

(ii) **Over–the–Counter Market** is a decentralized market (outside the stock exchange) with customized procedures.

The above classification is not rigid. One market may come under more than one category.

4.04 Role of Financial Market

One of the important requisites for the accelerated development of an economy is the existence of a dynamic and a resilient financial market. A financial market is of great use for a country as it helps the economy in the following manner:

(i) Savings Mobilization

Obtaining funds from the savers or 'surplus' units such as household individuals, business firms, public sector units, Government is an important role played by financial markets.

(ii) Investment

Financial market plays a key role in arranging the investment of funds thus collected, in those units which are in need of the same.

(iii) National Growth

Financial markets contribute to a nation's growth by ensuring an unfettered flow of surplus funds to deficit units. Flow of funds for productive purposes is also made possible. It leads to overall economic growth.

(iv) Entrepreneurship Growth

Financial markets contribute to the development of the entrepreneurial class by making available the necessary financial resources.

(v) Industrial Development

The different components of financial markets help an accelerated growth of industrial and economic development of a country and thus contributing to raising the standard of living and the society's well-being.

4.05 Functions of Financial Markets

A financial market renders the following functions:

I. Intermediary Functions

The intermediary functions of a financial market include the following:

(i) **Transfer of Resources:** Financial markets facilitate the transfer of real economic resource from lenders to ultimate borrowers.

(ii) **Enhancing Income:** Financial markets allow lenders earn interest/dividend on their surplus investible funds and thus contributing to the enhancement of the individual and the national income.

(iii) **Productive Usage:** Financial markets allow for the productive use of the funds borrowed and thus enhancing the income and the gross national production.

(iv) **Capital Formation:** Financial markets provide a channel through which new savings flow to aid capital formation of a country.

(v) **Price Determination:** Financial markets allow for the determination of the price of the traded financial asset through the interaction of buyers and sellers. They provide a signal for the allocation of funds in the economy, based on the demand and supply, through the mechanism called price discovery processes.

(vi) **Sale Mechanism:** Financial market provides a mechanism for selling of a financial asset by an investor so as to offer the benefits of marketability and liquidity of such assets.

(vii) **Information:** The activities of the participants in the financial market result in the generation and the consequent dissemination of information to the various segments of the markets, so as to reduce the cost of transaction of financial assets.

II. Financial Functions

The financial functions of a financial market include the following:

(i) Providing the borrowers with funds so as to enable them to carry out their investment plans

(ii) Providing the lenders with earning assets so as to enable them to earn wealth by deploying the assets in productive ventures

(iii) Providing liquidity in the market so as to facilitate trading of funds.

4.06 New Issue Market Vs. Secondary Market

Since his private properties are held liable for satisfying business debts, he can get more financial assistance from others.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. One such classification is:

(i) Marketable assets

(ii) Non-marketable assets

BASIS FOR COMPARISON	NEW ISSUE MARKET	SECONDARY MARKET
Meaning	The market place for new shares is called primary market. (Initial Issues Market)	The place where formerly issued securities are traded is known as Secondary Market. (Resale Market)
Buying	Direct	Indirect
Financing	It supplies funds to budding enterprises and also to existing companies for expansion and diversification	It does not provide funding to companies
How can securities be sold?	Only once	Multiple times
Buying and Selling between	Company and Investors	Investors
Gained person	Company	Investors
Intermediary	Underwriters	Brokers
Price	Fixed price	Fluctuates, depends on the demand and supply force
Organizational difference	Not rooted to any specific spot or geographical location	It has physical existence

Marketable Assets

Marketable assets are those which can be easily transferred from one person to another without much hindrance. Example: Shares of Listed Companies, Government Securities, Bonds of Public Sector Undertakings etc.

Non-Marketable Assets

On the other hand, if the assets cannot be transferred easily, they come under this category. Example: Bank Deposits, Provident Funds, Pension Funds, National Savings Certificates, Insurance Policies etc.

DO YOU KNOW?

Financial Assets

In any financial transaction, there should be a creation or transfer of financial asset. Hence, the basic product of any financial system is the financial asset. A financial asset is one which is used for production or consumption or for further creation of assets. For instance, a buys equity shares and these shares are financial assets since they earn income in future.

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example X purchases land and buildings or gold and silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance if a building is bought for residence purposes, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

Key Words

Financial Market | Debt Market
Equity Market | New Issue Market

Exercise

I. Choose the Correct Answers:

1. Financial market facilitates business firms

a) To rise funds
b) To recruit workers
c) To make more sales
d) To minimize fund requirement

2. Capital market is a market for

a) Short Term Finance
b) Medium Term Finance
c) Long Term Finance
d) Both Short Term and Medium Term Finance

3. Primary market is also called as

a) Secondary market b) Money market
c) New Issue Market d) Indirect Market

4. Spot Market is a market where the delivery of the financial instrument and payment of cash occurs

a) Immediately b) In the future
c) Uncertain d) After one month

5. How many times a security can be sold in a secondary market?

a) Only one time b) Two time
c) Three times d) Multiple times

Answers:

1	a	2	c	3	c	4	a	5	d

II. Very Short Answer Questions:

1. What are the components of organized sectors?
2. What is Spot Market?
3. What is Debt Market?
4. How is price decided in a Secondary Market?

III. Short Answer Questions:

1. Give the meaning of Financial Market.
2. Write a note on Secondary Market.
3. Bring out the scope of Financial Market in India.

IV. Long Answer Questions:

1. Distinguish between New issue market and Secondary Market. (any 5)
2. Enumerate the different types of Financial Markets. (any 5)
3. Discuss the role of Financial Market.

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