

UNIT I

Chapter - 1

Financial Market in india

Meaning of Financial System

A financial system functions as an intermediary between savers and investors. It facilitates the flow of funds from the areas of surplus to the areas of deficit. It is concerned about the money, credit and finance. These three parts are very closely interrelated with each other and depend on each other.

A financial system may be defined as a set of institutions, instruments and markets which promotes savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors).

In the words of Van Horne, ***“financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption”***.

Thus financial system is a set of complex and closely interlinked financial institutions, financial markets, financial instruments and services which facilitate the transfer of funds. Financial institutions mobilise funds from suppliers and provide these funds to those who demand them. Similarly, the financial markets are also required for movement of funds from savers to intermediaries and from intermediaries to investors. In short, financial system is a mechanism by which savings are transformed into investments.

Functions of Financial System

The financial system of a country performs certain valuable functions for the economic growth of that country. The main functions of a financial system may be briefly discussed as below:

1. **Saving function:** An important function of a financial system is to mobilise savings and channelize them into productive activities. It is through financial system the savings are transformed into investments.
2. **Liquidity function:** The most important function of a financial system is to provide money and monetary assets for the production of goods and services. Monetary assets are those assets which can be converted into cash

or money easily without loss of value. All activities in a financial system are related to liquidity-either provision of liquidity or trading in liquidity.

3. **Payment function:** The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced.

4. **Risk function:** The financial markets provide protection against life, health and income risks. These guarantees are accomplished through the sale of life, health insurance and property insurance policies.

5. **Information function:** A financial system makes available price-related information. This is a valuable help to those who need to take economic and financial decisions. Financial markets disseminate information for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment or holding a particular asset.

6. **Transfer function:** A financial system provides a mechanism for the transfer of the resources across geographic boundaries.

7. **Reformatory functions:** A financial system undertaking the functions of developing, introducing innovative financial assets/instruments services and practices and restructuring the existing assts, services etc, to cater the emerging needs of borrowers and investors (financial engineering and re engineering).

8. **Other functions:** It assists in the selection of projects to be financed and also reviews performance of such projects periodically. It also promotes the process of capital formation by bringing together the supply of savings and the demand for investible funds.

Role and Importance of Financial System in Economic Development

1. It links the savers and investors. It helps in mobilizing and allocating the savings efficiently and effectively. It plays a crucial role in economic development through saving-investment process. This savings – investment process is called capital formation.

2. It helps to monitor corporate performance.

3. It provides a mechanism for managing uncertainty and controlling risk.

4. It provides a mechanism for the transfer of resources across geographical boundaries.

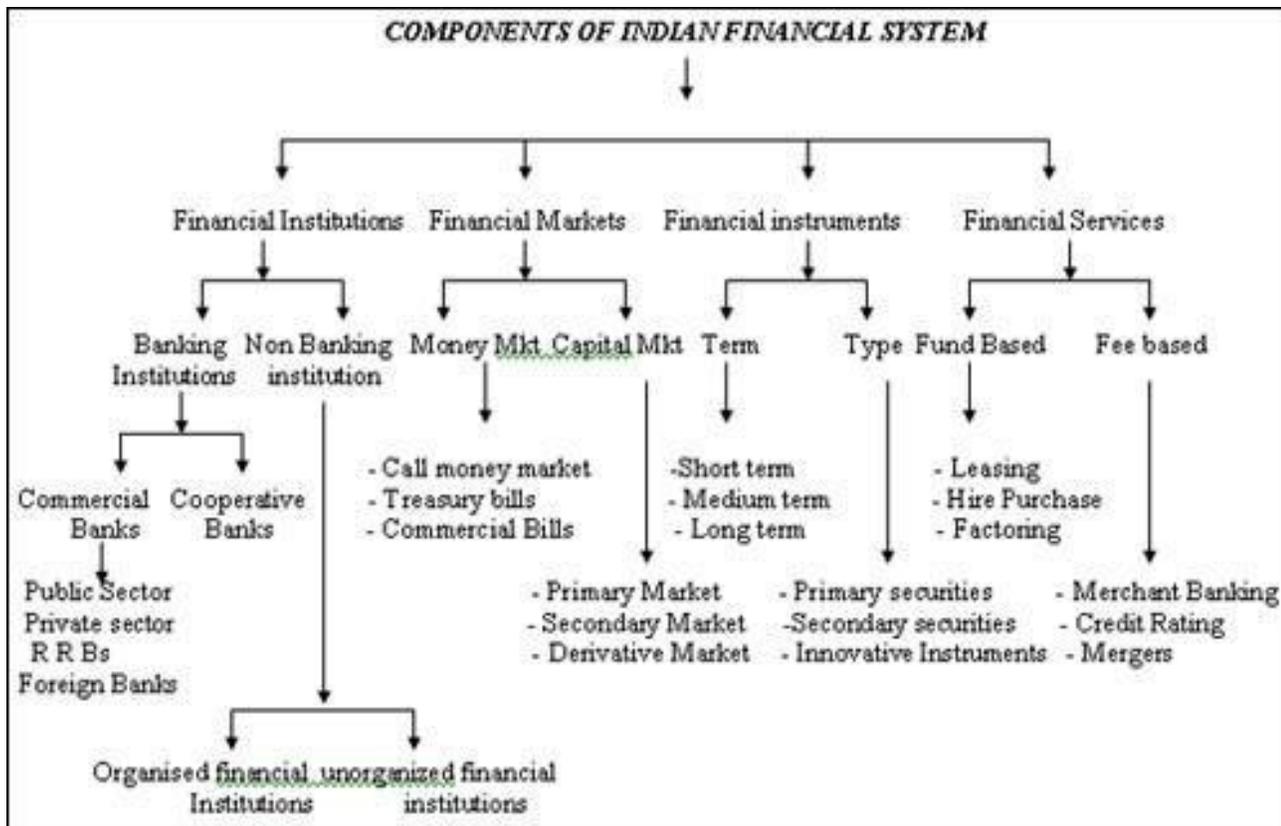
5. It offers portfolio adjustment facilities (provided by financial markets and financial intermediaries).
6. It helps in lowering the transaction costs and increase returns.
This will motivate people to save more.
7. It promotes the process of capital formation.
8. It helps in promoting the process of financial deepening and broadening. Financial deepening means increasing financial assets as a percentage of GDP and financial broadening means building an increasing number and variety of participants and instruments.

In short, a financial system contributes to the acceleration of economic development. It contributes to growth through technical progress.

Structure of Indian Financial System

Financial structure refers to shape, components and their order in the financial system. The Indian financial system can be broadly classified into formal (organised) financial system and the informal (unorganised) financial system. The formal financial system comprises of Ministry of Finance, RBI, SEBI and other regulatory bodies. The informal financial system consists of individual money lenders, groups of persons operating as funds or associations, partnership firms consisting of local brokers, pawn brokers, and non-banking financial intermediaries such as finance, investment and chit fund companies.

The formal financial system comprises financial institutions, financial markets, financial instruments and financial services. These constituents or components of Indian financial system may be briefly discussed as below:



I. Financial Markets

Financial markets are another part or component of financial system. Efficient financial markets are essential for speedy economic development. The vibrant financial market enhances the efficiency of capital formation. It facilitates the flow of savings into investment. Financial markets bridge one set of financial intermediaries with another set of players. Financial markets are the backbone of the economy. This is because they provide monetary support for the growth of the economy. The growth of the financial markets is the barometer of the growth of a country's economy.

Financial market deals in financial securities (or financial instruments) and financial services. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. These are the markets in which money as well as monetary claims is traded in. Financial markets exist wherever financial transactions take place. Financial transactions include issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank account, transfer of funds from a current account to a savings account etc.

The participants in the financial markets are corporations, financial

institutions, individuals and the government. These participants trade in financial products in these markets. They trade either directly or through brokers and dealers.

In short, financial markets are markets that deal in financial assets and credit instruments.

Functions of Financial Markets:

The main functions of financial markets are outlined as below:

1. To facilitate creation and allocation of credit and liquidity.
2. To serve as intermediaries for mobilisation of savings.
3. To help in the process of balanced economic growth.
4. To provide financial convenience.
5. To provide information and facilitate transactions at low cost.
6. To cater to the various credits needs of the business organisations.

Classification of Financial Markets:

There are different ways of classifying financial markets. There are mainly five ways of classifying financial markets

1. **Classification on the basis of the type of financial claim:** On this basis, financial markets may be classified into debt market and equity market.

Debt market: This is the financial market for fixed claims like debt instruments.

Equity market: This is the financial market for residual claims, i.e., equity instruments.

2. **Classification on the basis of maturity of claims:** On this basis, financial markets may be classified into money market and capital market.

Money market: A market where short term funds are borrowed and lend is called money market. It deals in short term monetary assets with a maturity period of one year or less. Liquid funds as well as highly liquid securities are traded in the money market. Examples of money market are Treasury bill market, call money market, commercial bill market etc. The main participants in this market are banks, financial institutions and government. In short, money market is a place where the demand for and

supply of short term funds are met.

Capital market: Capital market is the market for long term funds. This market deals in the long term claims, securities and stocks with a maturity period of more than one year. It is the market from where productive capital is raised and made available for industrial purposes. The stock market, the government bond market and derivatives market are examples of capital market. In short, the capital market deals with long term debt and stock.

3. **Classification on the basis of seasoning of claim:** On this basis, financial markets are classified into primary market and secondary market.

Primary market: Primary markets are those markets which deal in the new securities. Therefore, they are also known as *new issue markets*. These are markets where securities are issued for the first time. In other words, these are the markets for the securities issued directly by the companies. The primary markets mobilise savings and supply fresh or additional capital to business units. In short, primary market is a market for raising fresh capital in the form of shares and debentures.

Secondary market: Secondary markets are those markets which deal in existing securities. Existing securities are those securities that have already been issued and are already outstanding. Secondary market consists of stock exchanges. Stock exchanges are self regulatory bodies under the overall regulatory purview of the Govt. /SEBI.

4. **Classification on the basis of structure or arrangements:** On this basis, financial markets can be classified into organised markets and unorganized markets.

Organised markets: These are financial markets in which financial transactions take place within the well established exchanges or in the systematic and orderly structure.

Unorganised markets: These are financial markets in which financial transactions take place outside the well established exchange or without systematic and orderly structure or arrangements.

5. **Classification on the basis of timing of delivery:** On this basis, financial markets may be classified into cash/spot market and forward / future market.

Cash / Spot market: This is the market where the buying and selling

of commodities happens or stocks are sold for cash and delivered immediately after the purchase or sale of commodities or securities.

Forward/Future market: This is the market where participants buy and sell stocks/commodities, contracts and the delivery of commodities or securities occurs at a pre-determined time in future.

6. **Other types of financial market:** Apart from the above, there are some other types of financial markets. They are foreign exchange market and derivatives market.

Foreign exchange market: Foreign exchange market is simply defined as a market in which one country's currency is traded for another country's currency. It is a market for the purchase and sale of foreign currencies.

Derivatives market: The derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the derivative market. It is a market in which derivatives are traded. In short, it is a market for derivatives. The important types of derivatives are forwards, futures, options, swaps, etc.