UNIT II
FINANCIAL MARKETS

1. What is money market? Explain the functions of money market.

Ans. The money market is an organized exchange market where participants can lend and borrow short-term, high-quality debt securities with average maturities of one year or less. It enables governments, banks, and other large institutions to sell short-term securities to fund their short-term cash flow needs. Money markets also allow individual investors to invest small amounts of money in a low-risk setting.

Functions of the Money Market

The money market contributes to the economic stability and development of a country by providing short-term liquidity to governments, commercial banks, and other large organizations. Investors with excess money that they do not need can invest it in the money market and earn interest. Here are the main functions of the money market:

(i) Provides Funds: It provides short-term funds to the public and private institutions needing such financing for their working capital requirements. It is done by discounting trade bills through commercial banks, discount houses, brokers and acceptance houses. Thus the money market helps the development of commerce, industry and trade within and outside the country.

(ii)Use of Surplus Funds: It provides an opportunity to banks and other institutions to use their surplus funds profitably for a short period. These institutions include not only commercial banks and other financial institutions but also large non-financial business corporations, states and local governments.

(iii)No Need to Borrow from Banks: The existence of a developed money market removes the necessity of borrowing by the commercial banks from the central bank. If the former find their reserves short of cash requirements they can call in some of their loans from the money market. The commercial banks prefer to recall their loans rather than borrow from the central banks at a higher rate of interests.

(iv) Helps Government: The money market helps the government in borrowing short-term funds at low interest rates on the basis of treasury bills. On the other hand, if the government were to issue paper money or borrow from the central bank. It would lead to inflationary pressures in the economy.

(v)Helps in Monetary Policy: A well-developed money market helps in the successful implementation of the monetary policies of the central bank. It is through the money market that the central bank is in a position to control the banking system and thereby influence commerce and industry.

(vi)Helps in Financial Mobility: By facilitating the transfer for funds from one sector to another, the money market helps in financial mobility. Mobility in the flow of funds is essential for the development of commerce and industry in an economy.

(vii) Promotes Liquidity and Safety: One of the important functions of the money market is that it promotes liquidity and safety of financial assets. It thus encourages savings and investments.

(viii)Equilibrium between Demand and Supply of Funds: The money market brings equilibrium between the demand and supply of loanable funds. This it does by allocating saving into investment channels. In this way, it also helps in rational allocation of resources.

(ix)Economy in Use of Cash: As the money market deals in near-money assets and not money proper, it helps in economising the use of cash. It thus provides a convenient and safe way of transferring funds from one place to another, thereby immensely helping commerce and industry.

2. Name and explain the different Organisations/Institutions of the Money Market.

Ans. The various financial institutions which deal in short term loans in the money market are its members.

They comprise the following types of institutions:

(i)Central Bank: The central bank of the country is the pivot around which the entire money market revolves. It acts as the guardian of the money market and increases or decreases the supply of money and credit in the interest of stability of the economy. It does not itself enter into direct transactions. But control the money market through variations in the bank rate and open market operations.

(ii)Commercial Banks: Commercial banks also deal in short-term loans which they lend to business and trade. They discount bills of exchange and treasury bills, and lend against promissory notes and through advances and overdrafts.

(iii)Non-bank Financial Intermediaries: Besides the commercial banks, there are non-bank financial intermediaries which lend short-term funds to borrowers in the money market. Such financial intermediaries are savings banks, investment houses, insurance companies, provident funds, and other financial corporations.

(iv)Discount Houses and Bill Brokers: In developed money markets, private companies operate discount houses. The primary function of discount houses is to discount bills on behalf of other. They, in turn, form the commercial banks and acceptance houses. Along with discount houses, there are bill brokers in the money market who act as intermediaries between borrowers and lenders by discounting bills of exchange at a nominal commission. In underdeveloped money markets, only bill brokers operate.

(v) Acceptance Houses: The institution of acceptance houses developed from the merchant bankers who transferred their headquarters to the London Money Market in the 19th and the early 20 the century. They act as agents between exporters and importers and between lender and borrower

traders. They accept bills drawn on merchants whose financial standing is not known in order to make the bills negotiable in the London Money Market. By accepting a trade bill they guarantee the payment of bill at maturity.
However, their importance has declined because the commercial banks have undertaken the acceptance business. All these institutions which comprise the money market do not work in isolation but are interdependent and interrelated with each other.

3. What are Money Market Instruments? What are the different types of Money Market Instruments?

Ans. Financial instruments with short term maturity up to 1 year, used as tools for raising capital by the issuer are known as money market instruments.

These are debt securities that offer a fixed interest rate and are generally unsecured. There is no collateral backing up the security, and the risk of non-repayment is theoretically high. However, money market instruments have a high credit rating ensuring that issuers don't default, which makes them a go-to avenue for investors looking for options to park their money for the short term and earn fixed returns on the same.

Types of Money Market Instruments:

(i)Call /Notice-Money: Call/Notice money is the money borrowed on demand for a very short period. When money is lent for a day it is known as Call Money. Intervening holidays and Sunday are excluded for this purpose. Thus money borrowed on a day and repaid on the next working day is Call Money. When the money is borrowed or lent for more than a day up to 14 days it is called Notice Money. No collateral security is required to cover these transactions.

(ii)Term Money: Deposits with maturity period beyond 14 days is referred to as the term money. The entry restrictions are the same as that of Call/Notice Money, the specified entities not allowed to lend beyond 14 days.

(iii)Treasury Bills: Treasury Bills are short-term (up to one year) borrowing instruments of the union government. It's a promise by the Government to pay the stated sum after the expiry of the stated period from the date of issue (less than one year). They are issued at a discount off the face value and on maturity, the face value is paid to the holder.

(iv)Certificate of Deposits: Certificates of Deposits is a money market instrument issued in dematerialised form or as a Promissory Note for funds deposited at a bank, other eligible financial institution for a specified period.

(v)Commercial Paper: CP is a note in evidence of the debt obligation of the issuer. On issuing commercial paper the debt is transformed into an instrument. CP is an unsecured promissory note privately placed with investors at a discount rate of face value determined by market forces.

4. Give an overview of Money Markets in India.

Ans. Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. The money market can further be divided into two types:

(i)Unorganized Market: It consists of Moneylenders, Indigenous Bankers, Chit Funds, etc.

(ii)Organized Money Market: It consists of Treasury Bills, Commercial Paper, Certificate Of Deposit, Call Money Market and Commercial Bill Market. Organised Markets work as per the rules and regulations of RBI. RBI controls the Organized Financial Market in India. These are discussed below:

See types of money market instrument – Question No. 3

5. Explain the role of Central Bank operation in money market.

Ans. In every country, there is one bank which acts as the leader of the money market – supervising, controlling and regulating the activities of Commercial Banks and other financial institutions is called Central Bank. Central Bank is played a significant role operation of money market. These are discussed below:

(i) Firstly the central bank could do this by setting a necessary reserve ratio, which would restrict the ability of the commercial banks to increase the money supply by loaning out money. If this condition were above the ratio the commercial banks would have wished to have then the banks will have to create fewer deposits and make fewer loans then they could otherwise have profitably done. If the central bank imposed this requirement in order to reduce the money supply, the commercial banks will probably be unable to borrow from the central bank in order to increase their cash reserves if they wished to make further loans. They might try to attract further deposits from customers by raising their interest rates but the central bank may retaliate by increasing the necessary reserve ratio.

(ii) The central bank can influence the supply of money through special deposits. These are deposits at the central bank which the banking sector is required to lodge. These are then frozen, thus preventing the sector from accessing them even though interest is paid at the average Treasury bill rate. Making these special deposits reduces the level of the commercial banks' operational deposits which forces them to cut back on lending.

(iii) The supply of money can also be prohibited by the central bank by adjusting its interest rate which it charges when the commercial banks wish to borrow money (the discount rate). Banks generally have a ratio of cash to deposits which they consider to be the minimum safe level. If command for cash is such that their reserves fall below this level they will able to borrow money from the central bank at its discount rate. If market rates were 8% and the discount rate were also 8%, then the banks might decrease their cash reserves to their minimum ratio knowing that if demand exceeds supply they will be able to borrow at 8%. The central bank, even if, may raise its discount rate to a value above the market level, in order to encourage banks not to reduce their cash reserves to the minimum during excess loans. By raising the discount value to such a level, the commercial banks are given an incentive to hold more reserves thus reducing the money multiplier and the money supply.

(iv) Another way the money supply can be affected by the central bank is through its operation of the interest rate. By raising or lowering interest rates the demand for money is respectively reduced or increased. If it sets them at a certain level it can clear the market at level by supplying sufficient money to match the demand. Alternatively it could fix the money supply at a convinced rate and let the market clear the interest rates at the balance. Trying to fix the money supply is not easy so central banks regularly set the interest rate and provide the amount of money the market demands.

(v)The central bank may also involve the money supply through operating on the open market. This allows it to influence the money supply through the financial base. It may choose to either buy or sell securities in the marketplace which will either inject or remove money respectively. Thus the monetary base will be affected causing the money supply to modify.

6. What is Capital Market? Explain the functions of capital market.

Ans. The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long-term securities which have a maturity period of above one year.
In this market, the buyers use funds for longer-term investment. The nature of the capital market is risky markets. Therefore, it is not used for short-term funds investment.

Functions of Capital Market

(i)Links Savers and Investors: The capital market serves an intermediary between the people having excess funds and the ones who are in need of funds. It channels the ideal lying resources to more productive sources where it can generate income and increase productivity. It mobilises people's savings by directing and guiding them for productive investment. These investments provide regular income and growth to the investors.

(ii)Capital Formation: The capital market has an efficient role in capital formation in the economy. It fulfils and caters to the financial needs of different sectors of the economy by providing them with sufficient funds timely. It transfers funds from ideal lying sources to more productive and development sources.
It mobilises the saving of peoples through investments and lends that money for large development projects in the economy. This way it fulfils the overall fund requirement and helps in adding on to the existing stock of capital in the economy.

(iii)Regulate Security Prices: It helps in regulating the stable and systematic prices of securities. The capital market continuously monitors the trading of securities. It keeps an eye over whole processes and avoids any unproductive and speculative activities. Funds are provided at standard and minimum interest rates to the borrower. This helps in security prices stabilisation in the economy.

(iv)Provision of Investment Avenues: The capital market provides different long term investment avenues to the investors looking for long term investments. It deals in trading of long term securities thereby raising and lending money for long periods. It provides and offers good interest rates options to the people for investing their surplus funds. People are encouraged to invest their fund and earn regular income in the form of interest.

(v)Economic Growth and Development: It helps in economic growth and development in the country. Capital market speeds up the economic growth rate in the country by providing funds among different sectors of the economy continuously.
It provides funds for the large infrastructural development requiring huge funds in the country. Long term finance requirement of various business houses are met by the capital market. Thereby it improves the productivity of the economy by improving infrastructural facilities and generation of employment.

(vi) Minimises Transaction Cost and Time: The capital market facilitates the trading of long-term securities. It reduces the overall cost and time involved in the whole trading process. The entire trading process is conducted electronically through automated systems and programs which speed up the entire process.

(vii)Continuous Availability of Funds: The capital market ensures the sufficient availability of funds in the economy. It continuously provides long term investment avenues to investors. It is a liquid market as buyers and sellers of securities are continuously available here. It always circulates funds among the different sectors of society, thereby ensuring adequate availability of funds.

7. Name and explain the different Organisations/Institutions of the Capital Market.

Ans. Broadly speaking the capital market is classified in to two categories. They are the Primary market (New Issues Market) and the Secondary market (Old (Existing) Issues Market). This classification is done on the basis of the nature of the instrument brought in the market. However on the basis of the types of institutions involved in capital market, it can be classified into various categories such as the Government Securities market or Gilt-edged market, Industrial Securities market, Development Financial Institutions (DFIs) and Financial intermediaries. These are discussed below:

(i)Government Securities Market: This is also known as the Gilt-edged market. This refers to the market for government and semi-government securities backed by the Reserve Bank of India (RBI).

(ii)Industrial Securities Market: This is a market for industrial securities i.e. market for shares and debentures of the existing and new corporate firms. Buying and selling of such instruments take place in this market. This market is further classified into two types such as the New Issues Market (Primary) and the Old (Existing) Issues Market (secondary).
In primary market fresh capital is raised by companies by issuing new shares, bonds, units of mutual funds and debentures.
However in the secondary market already existing i.e old shares and debentures are traded. This trading takes place through the registered stock exchanges. In India we have three prominent stock

exchanges. They are the Bombay Stock Exchange (BSE), the National Stock Exchange (NSE) and Over The Counter Exchange of India (OTCEI).

(iii)Development Financial Institutions (DFIs): This is yet another important segment of Indian capital market. This comprises various financial institutions. These can be special purpose institutions like IFCI, ICICI, SFCs, IDBI, IIBI, UTI, etc. These financial institutions provide long term finance for those purposes for which they are set up.

(iv)Financial Intermediaries: The fourth important segment of the Indian capital market is the financial intermediaries. This comprises various merchant banking institutions, mutual funds, leasing finance companies, venture capital companies and other financial institutions.

8. Write a short note on Classification of instruments of Capital Market.

Ans.: Instruments in capital markets can be classified into three categories: Pure, Hybrid and Derivatives.

(1) Pure Instruments: Equity shares, preference shares, debentures and bonds which are issued with the basic characteristics without mixing the features of other instruments are called pure instrument.

(2) Hybrid Instruments: Instruments which are created by combining the features of equity, preference, and bond are called as hybrid instruments.

Example of Hybrid instruments are:
(a) Convertible preference shares.
(b)Non-convertible debentures with equity warrant.
(c) Partly convertible debentures.
(d) Secured premium notes.

(3) Derivative Instrument: A derivative instrument is a financial instrument which derives its value from the value of some other financial instrument or variable.
Example: Futures and Options belong to the categories of derivatives.

9. What is Debt Market? Give the classification of Indian Debt Market.

Ans. Debt market refers to the financial market where investors buy and sell debt securities, mostly in the form of bonds. These markets are important source of funds, especially in a developing economy like India. India debt market is one of the largest in Asia. Like all other countries, debt market in India is also considered a useful substitute to banking channels for finance.

The most distinguishing feature of the debt instruments of Indian debt market is that the return is fixed. This means, returns are almost risk-free. This fixed return on the bond is often termed as the 'coupon rate' or the 'interest rate'. Therefore, the buyer (of bond) is giving the seller a loan at a fixed interest rate, which equals to the coupon rate.

Classification of Indian Debt Market:

Indian debt market can be classified into two categories:

(i)Government Securities Market (G-Sec Market): It consists of central and state government securities. It means that, loans are being taken by the central and state government. It is also the most dominant category in the India debt market.

(ii)Bond Market: It consists of Financial Institutions bonds, corporate bonds and debentures and Public Sector Units bonds. These bonds are issued to meet financial requirements at a fixed cost and hence remove uncertainty in financial costs.

10. What is Equity Market? Give the classification of Indian Equity Market.

Ans. Equity market (often referred to as the stock market) is a financial market in which shares are issued and traded through exchanges. Stocks are essentially securities that are a claim on the earnings and assets of a corporation.
An example of an equity instrument would be common stock shares, such as those traded on the New York Stock Exchange.

Equity markets consist of: Primary market and secondary market.

(a) Primary Market: Primary market is that part of the capital markets that deals with the issuance of new securities. Companies, governments or public sector institutions can obtain funding through the sale of a new shares or bond issue. The primary market is the market where the securities are sold for the first time. Therefore it is also called the New Issue Market (NIM).

The issue of securities by companies can take place in any of the following methods: - Initial public offer - Further issue of capital - Rights issue - Firm allotment - Offer to public - Bonus issue

(b) Secondary Market: The secondary market, also known as the aftermarket, is the financial market where previously issued securities and financial instruments such as stock, bonds, options, and futures are bought and sold. The stock market or secondary market ensures free marketability, negotiability and price discharge.

Secondary market has further two components:
Spot Market: Where securities are traded for immediate delivery and payment.
Futures Market: Where the securities are traded for future delivery and payment

11. Distinguish between Debt Market and Equity Market

Ans.

Points	Debt Market	Equity Market
1.Meaning	The debt market is the market where debt instruments are traded.	The equity market is the market where equity shares are traded.
2.Instruments	In debt instruments includes debentures, bonds, Notes & Mortgages.	In equity market equity and preference shares are traded.
3.Status of	Debt instrument holders are creditors of	Equity holders are the owners of the

holder	the issuing companies.	issuing companies.
Risk	Investments in debt securities typically involve less risk than equity investments.	Investments in equity typically involve more risk than debt investments.
4.Volatility	Debt market is less volatile.	Equity market is more volatile.
5.Returns	In debt market there is less risk and hence returns are also low.	Equity market is more risky and may offer attract and higher return as compared to debt market.
6.Income	Income of debt market is fixed.	Income in equity market is variable.

12. Explain the role of stock market in the economic development of India.

Ans. Stock exchanges/market plays a crucial role in the economic development of industrial sector in particular. In the present days, stock exchanges play a cardinal role in promoting the level of capital formation through effective mobilization of savings and ensuring investment safety. The role of stock exchange in the capital market of India is described below:-

(i)Effective mobilization of savings: Stock exchange provides organized market for individual as well as institutional investors. They regulate the trading transactions with proper rules and regulations in order to ensure investor's protection. This helps to consolidate the confidence of investors and small savers.

(ii)Liquidity of investment: Stock exchange provides liquidity of investment to the investors. Investors can sell out any of their investments in securities at any time during trading days and trading hours on stock exchanges. Thus, stock exchanges provide liquidity of investment.

(iii)Investment safety: Stock exchanges through their by-laws, securities and exchange board of India (SEBI) guidelines, transparent procedures try to provide safety to the investment in industrial securities. Government has established the national stock exchange (NSE) and over the country exchange of India (OTCEI) for investor's safety.

(iv)Barometer of National Economy: Stock exchange is taken as a Barometer of the economy of a country. Each economy is economically symbolized by its most significant stock exchange. Stock exchange serves the nation in several ways through its diversified economic services which Include Imparting liquidity to investments, providing marketability, enabling evaluation and ensuring price continuity of securities.

(v)Promoting capital formation: The funds mobilized through capital market are provided to the industries engaged in the production of various goods and services useful for the society. This leads to Capital formation and development of national assists. The savings mobilized are channelized into appropriate avenues of investment.

(vi)Corporate governance: Stock exchanges impose stringent rules to get listed in them. So listed public companies have better management records than privately held companies.

(vii)Government capital raising for developments project: They help government to rise fund for developmental activities through the issue of bonds. An investor who buys them will be lending money to the government which is more secure, and sometimes enjoys tax benefits also.

(viii)Profit sharing: They help both casual and professional stock investors, to get their share in the wealth of profitable businesses.

13. Distinguish between primary market and secondary market.

Ans.: The distinction between primary market and secondary market are as follows:

Basis	Primary Market	Secondary market
1.Meaning	A platform that offers security for the first time is the primary market.	The market where investor's trade already issued securities is known as the secondary market.
2.Issues	It deals with new issues of securities.	It deals with securities already in the market.
3.Another name	New issue market (NIM)	Aftermarket or share market.
4.Purpose	It is a link between savers and those needing money for long term investment.	It links buyers and sellers of securities.
5.Time	The period of investment is long.	The period of investment is short term and medium term.
6.Source	It matches financial requirements of corporate sector.	It provides marketability to securities.
7.Price	The price always remains fixed.	The price keeps on fluctuating depending on the demand and supply force.
8.Intermediaries	Underwriters are the intermediaries in the primary market.	Brokers are the intermediaries in the secondary market.

14. Distinguish between capital market and money market.

Ans. The distinctions between capital market and money market are briefly shown in the following table:

Basis	Money Market	Capital Market
1.Meaning	It is a market for short-term loanable funds for a period of not exceeding one year.	It is market for long-term funds exceeding a period one year.
2. Market Nature	Money markets are informal in	Capital markets are formal in nature.

	nature.	
3. Instruments	The instruments that are dealt in a money market are bills of exchange, treasury bills, commercial papers, certificate of deposit, etc.	This market deals in instruments like shares, debentures, Government, bonds, etc.
4.Investor Types	Commercial banks, non-financial institutions, central bank, chit funds, etc.	Stockbrokers, insurance companies, Commercial banks, underwriters, etc.
5.Market Liquidity	Money markets are highly liquid.	Capital markets are comparatively less liquid.
6.Risk Involved	Money markets have low risk.	Capital markets are riskier in comparison to money markets.
7.Maturity of Instruments	Money markets are highly liquid.	Capital markets are comparatively less liquid.
8.Purpose served	To achieve short term credit requirements of the trade.	To achieve long term credit requirements of the trade.
9.Return on investment achieved	ROI is usually low in money market.	ROI is comparatively high in capital market.
10.Place	Transactions mostly take place over-the-phone and there is no formal place.	Transactions take place at a formal place viz. stock exchange.

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