UPSC Civil Services Examination

UPSC Notes [GS-III]

Topic: Financial Market - UPSC Economy Notes

Financial Market refers to the system consisting of financial institutions, financial instruments, regulatory bodies and organisations. It facilitates the flow of debt and equity capital.

Banks, Development Financial Institutions (NABARD, SIDBI, IDBI etc.) and Non- Banking Financial Institutions form Financial Institutions.

Financial Instruments are shares, bonds, debentures etc.

Financial markets consist of two major segments:

1. Money Market: The market for short term funds
2. Capital Market: The market for long and medium-term funds.

There are two types of Capital Flow –

1. Lending
2. Borrowing

Money Market

According to the RBI, “The money market is the centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders.

It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government.”

Functions of Money Market

- To maintain the balance between the demand and supply for money when it comes to short-term money-related transactions(monetary equilibrium)
- To promote economic growth. Money market can do this by making funds available to various units in the economy such as agriculture, small scale industries, etc.
- To provide help to Trade and Industry. Money market provides adequate finance to trade and industry. Similarly, it also provides the facility of discounting bills of exchange for trade and industry.
- To help in implementing Monetary Policy. It provides a mechanism for the effective implementation of the monetary policy.
- To help in Capital Formation. Money market makes available investment avenues for short term period. It helps in generating savings and investments in the economy.

Features of Money Market

Money market provides non-inflationary sources of finance to the government. It is possible by issuing treasury bills in order to raise short loans. However, this does not lead to increases in prices.

Money Market consists of all the organizations and institutions which deal or facilitate dealings in short term debt instruments. These institutions include RBI, commercial banks, cooperative banks, non-banking financial companies like LIC, GIG, UTI and special institutions like Discount and Finance House of India (DFHI). The important money market instruments or securities (financial assets) are as follows.

Capital Market

The capital market is the market for medium and long term funds. It consists of all the financial institutions, organizations and instruments which deal in lending and borrowing transactions of over one-year maturity.

Types of Capital Market

Primary Market	Secondary Market
It issues security for the first time. Example- Initial public offer and follow on public offer.	Existing securities are bought and sold.
Firms issue shares to the public.	One investor sells it to another investor.
Price is fixed by the firms.	Price is fixed on the basis of demand and supply.
Firms raise money for long-term investment.	Companies benefit from the secondary markets.
There is no specific geographical location.	There is no specific geographical location.
Security & Exchange Board of India (SEBI) is the regulator for this market.	SEBI is the regulator for this market as well.

Difference between Money Market & Capital Market

Money Market	Capital Market
Deals with a short-term financial transaction. (up to 1 year)	Deals with medium and long-term

Net lenders are people. Firms borrow to invest money to buy raw materials. This is a short-term transaction. This is called working capital finance.	financial transaction. Medium 1-5 yrs. Long Term Over 5 years
Working capital finance.	Promotes capital formation.
Works only with bonds. Example: Commercial papers, commercial bills, treasury bills, treasury bills, commercial bills, treasury bills, etc.	Deals with both bonds and equity. Example: Debentures, shares, etc.
Deals with high volume transactions.	Deals with all value transactions.
Only banks are there.	All Financial Institutions are there.
The general public does not participate much in the money market. Money market.	The general public also participates significantly
Prime regulator is RBI.	Prime regulator is SEBI. IRDA, PFRDA (Pension Fund Regulatory Authority)

Major Terminologies – Financial Market

Treasury Bills: They are promissory notes issued by the RBI on behalf of the government as a short term liability and sold to banks and to the public. The maturity period ranges from 14 to 364 days. They are the negotiable instruments, i.e. they are freely transferable. No interest is paid on such bills but they are issued at a discount on their face value.

Commercial Bills: They are also called Trade Bills or Bills of Exchange. Commercial bills are drawn by one business firm to another in lieu of credit transaction. It is a written acknowledgement of the debt by the maker directing to pay a specified sum of money to a particular person. They are short-term instruments generally issued for a period of 90 days. These are freely marketable. Banks provide working capital finance to firms by purchasing the commercial bills at a discount; this is called 'discounting of bills'.

Commercial Paper (CP): The CP was introduced in 1990 on the recommendation of the Vaghul Committee. A commercial paper is an unsecured promissory note issued by corporate with a net worth of atleast Rs 5 crore to the banks for short term loans. These are issued at discount on face value for a period of 14 days to 12 months. These are issued in multiples of Rs 1 lakh subject to a minimum of Rs 25 lakh.

Certificate of Deposit (CD): The CD was introduced in 1989 on the recommendation of the Vaghul Committee. These are issued by banks against deposits kept by individuals and institutions for a period of 15 days to 3 years. These are similar to Fixed Deposits but are negotiable and tradable. These are issued in multiples of Rs. 1 lakh subject to a minimum of Rs25 lakh.

Discount and Finance House of India Ltd.: DFHI was set up as a subsidiary of RBI in 1988 on the recommendation of the Vaghul Committee. Its objective is to stimulate activity in, the money market by providing liquidity to the money market instrument. It buys bills and short term securities from banks and financial institution thereby developing a secondary market in them. DFHI was set up as a subsidiary of RBI in 1988 on the recommendation of the Vaghul Committee. Its objective is to stimulate activity in, the money market by providing liquidity to the money market instrument. It buys bills and short term securities from banks and financial institution thereby developing a secondary market in them.

To know more about the market economy status, refer to the linked article.

Gilt-Edged Market

The Gilt-edged market refers to the market for government and semi-government securities, backed by the RBI. The term gilt-edged means 'of the best quality'. It is known so because the government securities do not suffer from the risk of default and are highly liquid. The RBI is the sole supplier of such securities. These are demanded by commercial banks, insurance companies, provident funds and mutual funds.

The gilt-edged market may be divided into two parts- the Treasury bill market and the government bond market. Treasury bills are issued to meet short-term needs for funds of the government, while government bonds are issued to finance long-term developmental expenditure.