Topic-III
Money and Capital Markets

Role of Financial Markets(Banks+ Money Markets+ Capital Markets)

- Surplus Funds Sectors (Investors) are generally Households but can be Firms and Government also

- Deficit Funds Sectors (Fund Raisers) are generally Firms and Government but can be Households also

- Financial Markets constitutes of the institutions which allow enterprises and government to raise funds

Classification of Financial Markets

1. **Money Markets** deals with provision of raising short-term funds with maturity up to 1 Year while **Capital Markets** deals with provision of raising long-term funds with maturity greater than 1 Year.

2. **Primary Markets** are associated with sale and purchase of **new** securities while in **Secondary Markets** existing securities are bought and sold among investors.

Debt and Equity Markets

- **Debt Markets** involves trading in Debt instruments which allow the companies or government to **raise funds only by incurring debt** and the lender is guaranteed of a fixed repayment (Principal+Interest). e.g. Bonds

- **Under Equity or Share Markets**, funds can be raised without incurring debt. Those who finance enterprise by purchasing shares also gain partial ownership of the business. They also get dividends (part of profit) regularly.

Risks in Financial Markets

- For fund raisers, Primary Market is more important as the funds directly reach them, but at the same time it is riskier for them as the company does not know if the investors will buy their bonds or shares.

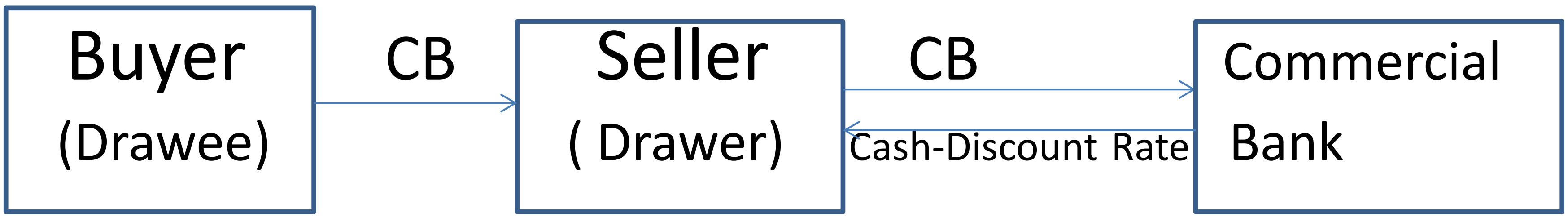
- For investors, Equity market is riskier than Debt market as debt instruments give fixed returns but shares give higher returns in long run. Therefore, risk-return trade-off.
- In case of liquidation of the company bond holders get their claim before share holders.

Money Market Instruments

1. Call Money Market

- Deals in One-Day loans or Call Loans
- Loans can be renewed up to 14 days and such loans come under Notice Money market
- Banks are the main participants and the market is sensitive to day-to-day cash position of the banks.
- Its Interest rate (Call Money Rate) is the best indicator of liquidity position in money market. e.g LIBOR, MIBOR etc.
- After 1989, Call Money Rate is market determined in India

Commercial Bills (CB)



- CBs are drawn by Seller on the Buyer for the value of goods provided by the Seller
- Maturity period is 3-6 months and Seller can approach bank for discounting the bill before maturity (getting Cash-Discount Rate)
- Bank can Rediscount the bill either with other banks or with RBI (at Bank Rate) making them Tradable

Other Money Market Instruments

- **Certificates of Deposit (CDs):** CDs are issued by Banks/selected Financial Institutions to raise short-term funds from the investors. Similar to Term Deposits except that they are Tradable.
- **Commercial Papers (CPs):** CPs are issued by the Corporate Sector to raise short-term funds from the investors. Are riskier & therefore can only be issued by Listed Companies with some working capital requirements. Are Tradable.
- **Treasury Bills (TBs):** TBs are issued by the Government to raise short-term funds.

Capital Markets: Debt Market

- Indian Debt Market primarily comprises of the Government Security (G-Sec) Market.
- A **Government Security/Bond** is issued by the Central/State Government to acknowledge the borrowings made by the government from the financial markets. Are Tradable.
- Short-Terms G-Sec with maturity less than 1 Year are called **Treasury Bills** (Money Market) while Long-term G-Sec with more than 1 year maturity are called **Dated Securities.**

- Bonds are less risky and since G-Secs are the bonds issued by Government which is least likely to default on its payment obligations, these are called **‘Gilt-Edged’** Securities or the Securities of Best Quality.
- RBI plays Regulatory role in the G Sec market by arranging the Primary Auction of securities.
- Primary Dealers (mostly Commercial banks or their subsidiaries) can participate in the auction to buy new G Sec.
- Commercial Banks, Foreign Investors and Insurance Companies are other important participants in the market.