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Financial Markets in India - II

Subject:	Business Economics
Course:	B. A., 4th Semester, Undergraduate
Paper No. & Title:	Paper – 404 Indian Financial System
Unit No. & Title:	Unit – 1 Financial Markets in India
Lecture No. & Title:	Lecture – 2 Financial Markets in India - II

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1. Introduction

Linkages between Economy and Financial Market

As we have seen how important financial markets are with their roles it can be said that any well developed, smoothly working financial market do contribute to the health and efficiency of an economy. There is a strong positive relationship between financial markets and economy of the nation. In this we can say that economic development creates demands for particular types of financial engagements. The financial market responds automatically to these demands.

Financial market is a part of financial system of any economy. There is a way as to how optimal financial system should look like. The optimal financial system in combination with a well-developed legal system should integrate both direct, market & indirect, bank-based finance. We are going to study direct market based finance and its effect on economic growth. There are certain points through which one can say how these both are linked which will be explained below.

Funnelling savings to firm

Improving the allocation of capital

Affecting the saving rate

Risk sharing

Household borrowing

Interest rate effects

A well-developed financial market with financial institutions would promote savings. It also encourages these savings to flow into financial assets as against physical assets. The flow of liquidity into physical assets such as gold, silver or real estate would nourish inflation. If the same flow in financial assets it is not only non-inflationary but would aid growth in the economy.

The financial system is also particularly important in reallocating capital. Thus it provides the base for the continuous reorganization of the economy which is needed to support growth. In countries with a highly developed financial market, we observe that a greater share of investment is allocated to relatively fast growing sectors. The reason is there are new financial assets which come up in financial markets.

The third way financial development can affect growth is by shifting the saving rates. The financial development may also reduce saving, and thereby growth. As capital markets develop, households gain better insurance against granted shocks and better diversification of rate-of-return risk. Credit becomes more readily and cheaply available. It also narrows the distance between the interest rate paid by firms and that received by households.

Financial markets enable people to share both endowment risks (such as health hazards) and rate-of-return risk (such as that due to the volatility of stock returns). People counter the first type of risk via insurance markets, if they exist. In an endogenous growth model, this fall in the saving rate lowers the growth rate. It also provides one instance in which financial development can retard growth but it can change the scenario if people invest in financial markets. Rate-of-return risk can be reduced by diversifying portfolios through securities markets.

Capital markets also get funds from households that save to those that do not save, in the form of consumer credit and mortgage loans. If the loan supply falls short of demand then it affects some households which are liquidity-constrained. The reason is their consumption is limited by current resources, rather than by permanent income. Thus mandatory liquidity constraints increase the saving rate, because young households cannot dis-save as much as they would like.

For some industries at certain times of their development, market-based financing is advantageous. As we all know financing through stock markets is ideal for industries. As such market brings continuous technological advances and there is little harmony on how firms should be managed.

The contribution of financial markets in this area is a necessity. It maintains the competitiveness of an economy today. Factors such as strongly increased international competition, rapid technological progress are responsible. The increased role of innovation for growth performance is also important.

2. Integration of Indian Financial Markets with Global markets

Among globalisation, deregulation and advances in information technology national stock markets have arisen as the major network. It is basically for financial integration of emerging market economies. There are different factors contributing to growing financial integration. One among them which is rapid increasing is the cross-border mobility of private capital inflows due to investors pursuing portfolio diversification and better returns. A growing belief of nations on the savings of other nations and a shift in the preference of companies from debt to equity finance is one main reason.

Financial integration usually comes with several benefits like development of markets and institutions. These are associated with effective price discovery leading to higher savings, more investment and economic progress. With benefits several risks also come such as contagion and associated disruption of economic activities. Such were experienced during the Asian crisis in late 1990s and recently in 2008 national markets declined badly due to credit market developments in United States.

Growing integration of Indian financial market with global and major regional market in Asia was experienced during the reform period beginning in the early 1990s. Bombay stock exchange (BSE) of India has emerged as the largest stock exchange in the world. It has occurred in terms of numbers of companies listed which consists of large, medium sized and small firms as well. With the option of integrating and internationalisation many companies decided to go for listing on stock exchanges of other countries especially United States and United Kingdom. Ten major Indian companies listed on New York stock exchange (NYSE) and NASDAQ account for a 19 per cent weight in the benchmark 30-scrip stock price index of the BSE. Fifty Indian companies are listed on the London Stock Exchange. Foreign capital flows have made a crucial contribution to the growth of India's stock market. India has become a major destination, representing about a fourth of total portfolio capital inflows to the emerging market economies (EMEs) group. The foreign institutional investors participating in India's stock market have been increasing each day in the equity market compared to debt market.

Within Asia, the Singapore and Hong Kong markets have significant influence. While the Japanese market has weak influence on the Indian market. The two global markets, the United States and the United Kingdom, could have a differential impact on the Indian market in the opposite direction. This impact is amid a structural shift in India’s integration with these global markets.

From a policy perspective, co-integrated stock markets would contribute to financial stability, since they cannot deviate too far from the long-run equilibrium path. From the standpoint of their portfolio diversification objective, investors cannot benefit from arbitrage activities in the long run. (Raj & Dhal, 2008)

3. Who are actively engaged in financial market?

Now let us see who are actively engaged in Financial Markets.

The parties like

1. Individuals
2. Firms
3. Corporates
4. Banks
5. Regulators
6. Government
7. Intermediaries like lead managers, bankers to the issue, registar, share tranfer agents
8. Depositories
9. Clearing corporations
10. Share brokers
11. Credit rating agencies
12. Underwriters
13. Custodians
14. Portfolio managers
15. Mutual funds

16. Investment companies

17. Dealers etc. are major players in financial markets.

4. Role of Regulatory Bodies (RBI & SEBI)

The need for a regulatory framework has been universally felt. It is to safeguard the interest of a large number of investors and also ensures proper functioning of the institutions.

In India the high level co-ordination committee for financial markets (HLCCFM) discusses various policy level issues. It requires inter-regulatory coordination between the regulators in financial market like RBI, SEBI, IRDA, PFDRA etc. But there are two principal regulatory authorities named RBI and SEBI which we are going to study now.

RBI (Reserve Bank of India)

In India the two principal regulatory authorities are RBI and SEBI. Though originally privately owned, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

Reserve bank of India is the apex institution which controls and monitors all the organizations in the organized sector. It controls the monetary policy of the country. RBI was established on 1st April 1935, 80 years ago in accordance with the provisions of the RBI Act, 1934. RBI was nationalized on 1st January 1949. Its central office is located in Mumbai since 1937. The RBI plays an important role in the development strategy of the government of India. The Reserve Bank of India is the central bank of the country.

The bank is also entrusted with the responsibility of promoting financial inclusion policy. The basic functions of RBI are to regulate the issue of bank notes, maintaining reserves to secure monetary stability. It also operates the currency and credit system in the best interests of the country.

Role of Reserve Bank of India

1. Monetary authority of the Country

   It is the central and important function of RBI. The broad objectives of this policy are to maintain price stability and ensuring adequate flow of credit to productive sectors for growth. It creates such conditions for growth and influencing the availability and cost of credit in the economy. It has made efforts to improve the volume of credit. It can be done by directing bank credit to certain credit required sectors such as agriculture, exports, small-scale industries, infrastructure, micro-credit and simplifying the access of credit.

2. Banker to the government

   Reserve Bank manages the public debt and banking needs of the central and state governments. It has to-maintain and operate the central government's public debt deposit accounts by government. It deposits all its cash balance with RBI free of interest. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.

3. Issuer of Currency

   The function of note issue and currency management has been delegated to RBI by the preamble to the RBI act, 1934. It acts as a sole currency authority under section 22 for issue of bank notes without any stamp duty. The government of

India issues one rupee coins and notes but they are put into circulation through RBI. In the management of currency it requires self-sufficiency in the production of notes, efficiency of distribution network, withdrawal and destruction of notes, technology up-gradation and enhancement in security features.

4. Manager of exchange control

One of the functions of RBI is to develop and regulate the foreign exchange market. It assists external trade with payment and promotes orderly development and maintenance of foreign exchange market in India. It introduces new instruments in the market. With pricing strategies and promotes financial assimilation of foreign exchange markets with other markets.

5. Credit Controller

Since credit money forms the most important part of supply of money. Since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Reserve Bank in accordance with the economic priorities of the government controls the credit.

5. SEBI (Securities Exchange Board of India)

Securities and Exchange Board of India (SEBI) was first established in the April 1988 as a non-statutory body for regulating the securities or capital market. It became an autonomous and statutory body in 1992. More powers were given through an ordinance for smooth functioning of capital market. Since then it regulates the market through its independent powers.

The Securities and Exchange Board of India (SEBI) is the regulator for the securities market in India. It was established in the year 1988 and given statutory powers on 12 April 1992 through the SEBI Act, 1992.

SEBI has to be responsive to the needs of three groups, which constitute the market:

- the issuers of securities
- the investors
- the market intermediaries

Proceeding to the topic of Role of SEBI

As mentioned in the provisions of the Act of SEBI it is the duty of the board to protect the interest of investors. Plus to promote the development of the market with the regulations. So basically there are two roles played by the SEBI

(A)Regulatory

(B)Developmental

(A) Regulatory

1. Regulation of stock exchanges for the business done on it and any other securities market.
2. To regulate and register the working of stock brokers, agents, bankers, merchant bankers, underwriters, portfolio managers, intermediaries who are associated with securities market.
3. Registering and regulating the collective investment schemes including mutual funds.
4. Forbid fraudulent and unfair practices related to securities market.

5. Another important role of SEBI is to Prohibit insider trading and there by prohibiting promoters and their closed groups to take undue advantages by trading in securities of their own companies based on price sensitive information they have.

6. SEBI also regulates significant acquisition of shares and takeover of companies.

Let us conclude the session by discussing the developmental role of SEBI

(B) Developmental

1. SEBI also promotes investors education and financial awareness regarding investment decisions.

2. SEBI also promotes self-regulatory organisations

3. SEBI is also engaged in training of intermediaries of securities market

4. SEBI promotes of fair practices and code of conduct for all SROs (Self Regulatory Organisation)

5. SEBI is also engaged in conducting and publishing research information which can be useful to many participants of the market.

6. Summary

In this session we discussed linkages between financial markets with world markets and integration of Indian Financial markets with World markets, players in financial markets and role of SEBI and RBI.