

AN OVERVIEW OF THE FINANCIAL MARKETS

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I. Definition of the Financial Market

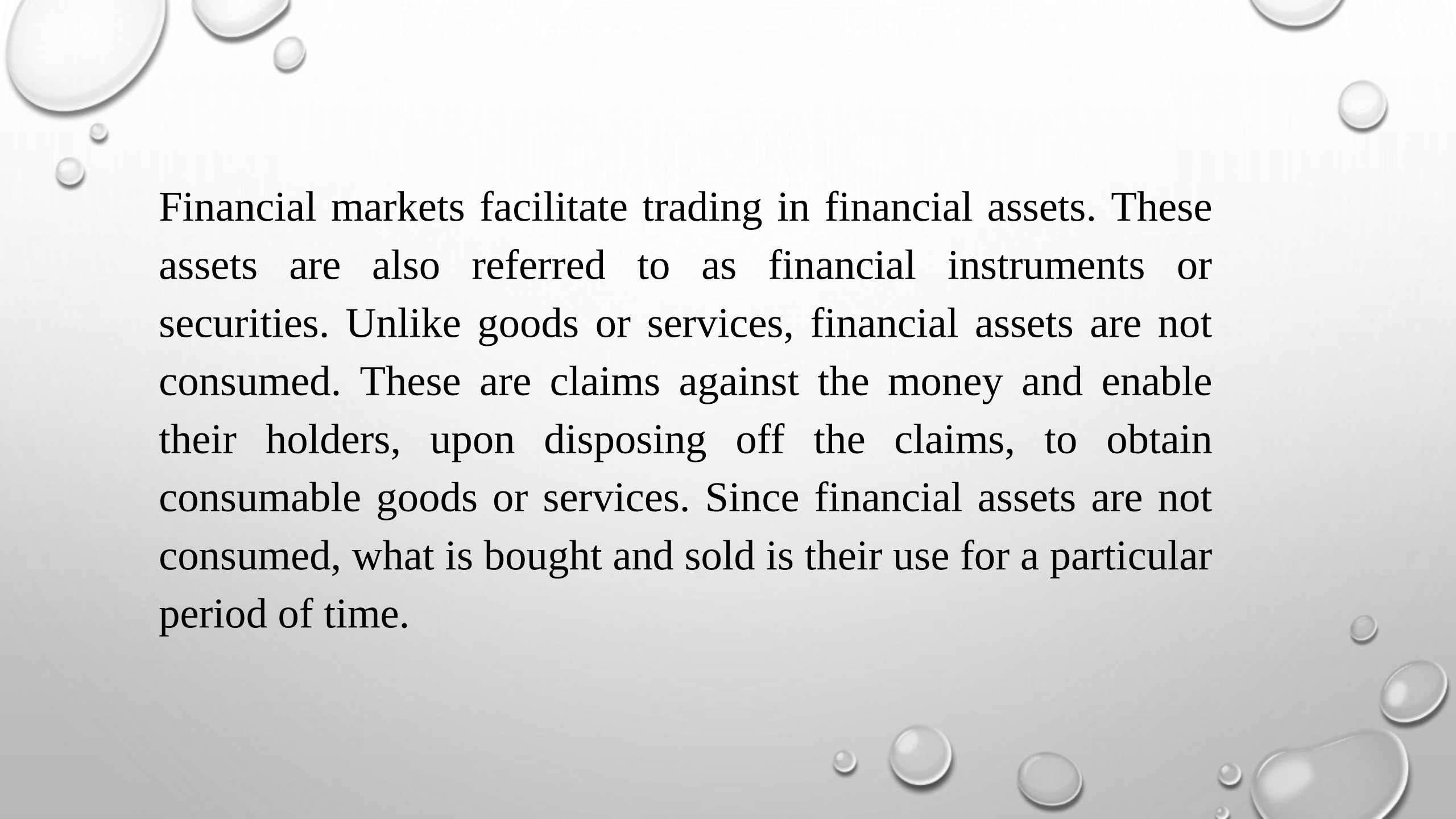
II. Importance of Financial Markets

III. Functions of Financial Markets

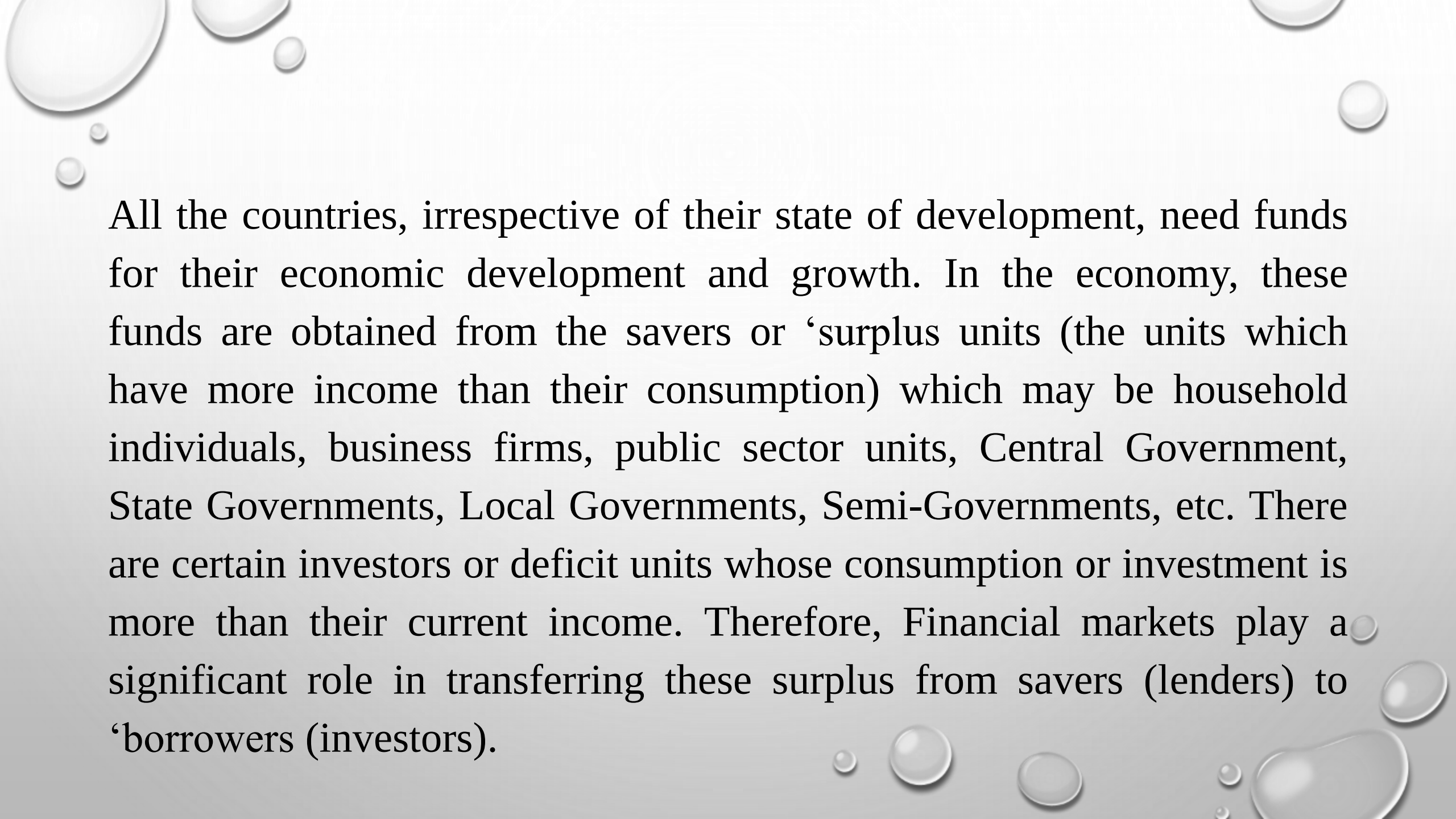
- **Economic Functions**
- **Financial Functions**

I. Definition of the Financial Market:

The term 'market' usually brings to mind a geographical place where people exchange goods and services. However, it is a narrow view of market and does not reflect that the term market includes mechanisms also. **Financial market**, like any other market; facilitates the exchange of financial assets among the dealers. In other words, it refers to place or mechanism where financial assets are sold and purchased. Further, financial market transaction may be at specific place or location, e.g. stock exchange or the same may be just through a particular mechanism like telephone, telex, or any other electronic media.

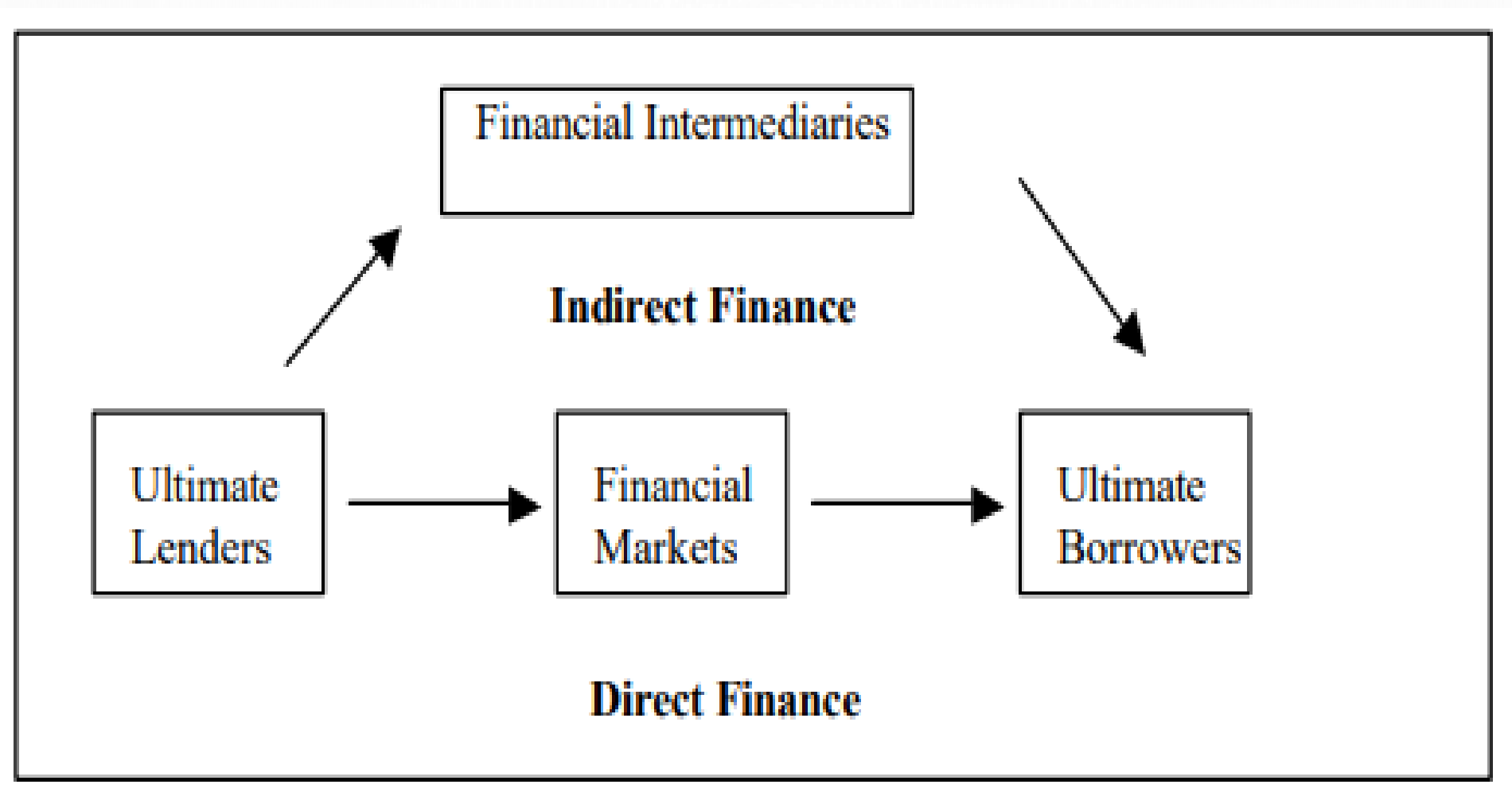


Financial markets facilitate trading in financial assets. These assets are also referred to as financial instruments or securities. Unlike goods or services, financial assets are not consumed. These are claims against the money and enable their holders, upon disposing off the claims, to obtain consumable goods or services. Since financial assets are not consumed, what is bought and sold is their use for a particular period of time.



All the countries, irrespective of their state of development, need funds for their economic development and growth. In the economy, these funds are obtained from the savers or 'surplus units (the units which have more income than their consumption) which may be household individuals, business firms, public sector units, Central Government, State Governments, Local Governments, Semi-Governments, etc. There are certain investors or deficit units whose consumption or investment is more than their current income. Therefore, Financial markets play a significant role in transferring these surplus from savers (lenders) to 'borrowers (investors).

This process is known as 'transmission mechanism'. In an economy, flow of surplus funds from surplus units to deficit units is essential for desired achievement of national goals and priorities. Thus, this flow must be in right direction and for productive purposes. For this, appropriate financial instruments and opportunities must be available. The financial markets provide the platform for such flow' where each saver can find and exchange the appropriate financial assets as per his requirement. So, the efficiency of financial market depends upon how efficiently the flow of funds is managed in an economy. Further, the financial market must induce people to become producers/entrepreneurs and motivate individuals and institutions to save more.



II. Importance of Financial Markets

There are many things that financial markets make possible, including the following:

- Financial markets provide a place where participants like investors and debtors, regardless of their size, will receive fair and proper treatment.
- They provide individuals, companies, and government organizations with access to capital.
- Financial markets help lower the unemployment rate because of the many job opportunities it offers

III. Functions of the Financial Markets

Functions of a financial market can be classified into two categories: Economic Functions, and Financial Functions.

a) Economic Functions

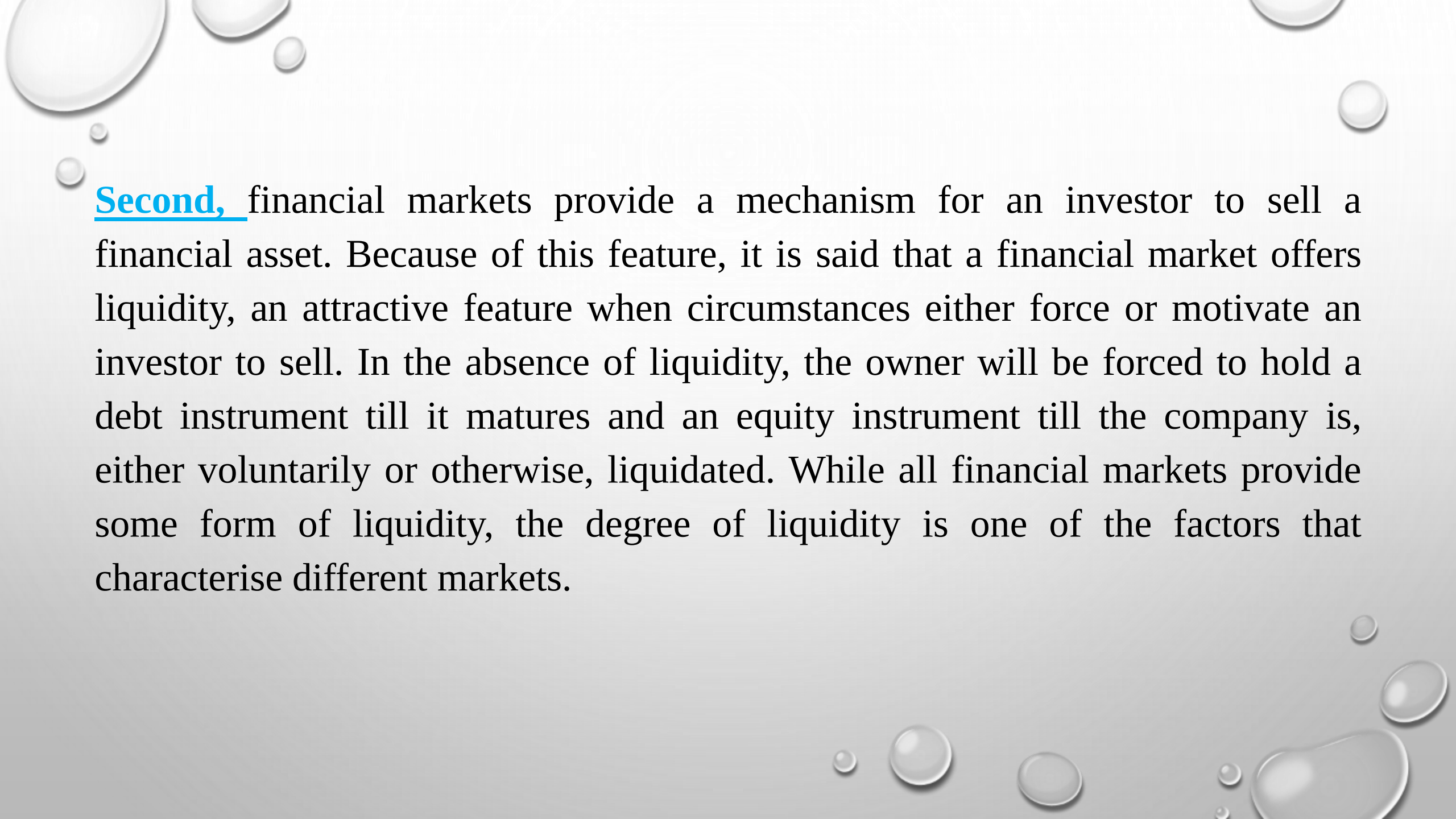
- It facilitates the transfer of real economic resources from lenders to ultimate borrowers.
- Lenders earn interest/dividend on their surplus invisible funds, thereby increasing their earnings, and as a result, enhancing national income finally.
- Borrowers will have to use borrowed funds productively, if invested in new assets, and hence increasing their income and gross national products finally.
- By facilitating transfer of real resources, it serves the economy and finally the welfare of the general public.
- It provides a channel through which new savings flow into capital formation of a country.



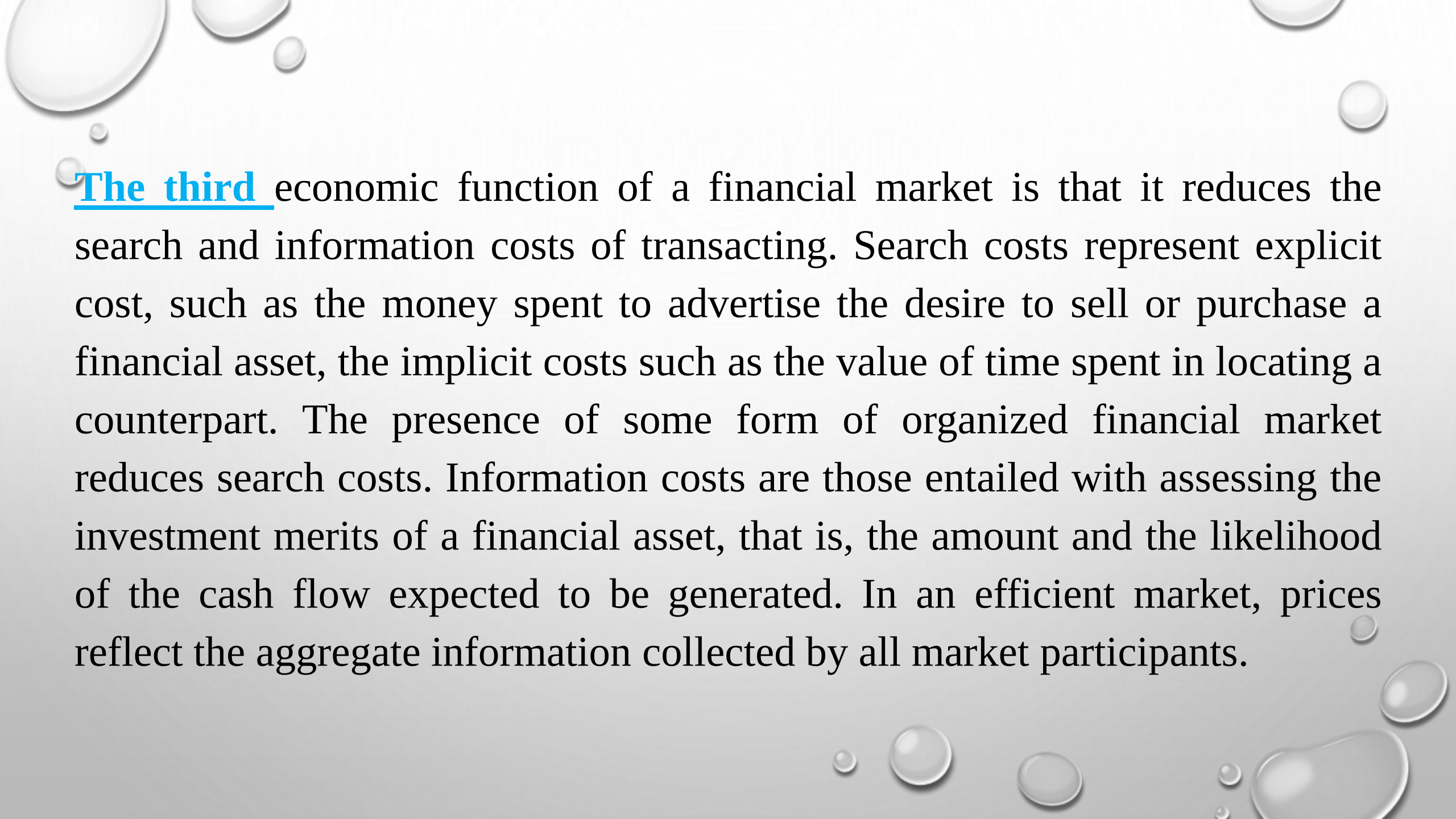
● **In addition to the above**, the financial markets perform three more economic functions:

First, the interaction of buyers and sellers in a financial market determines the price of the traded asset; or equivalently, the required return on a financial asset is determined. The inducement for firms to acquire funds depends on the required rate of return that investors demand, and it is this feature of financial markets that signals how the funds in the economy should be allocated among financial assets. This is called the price discovered process.

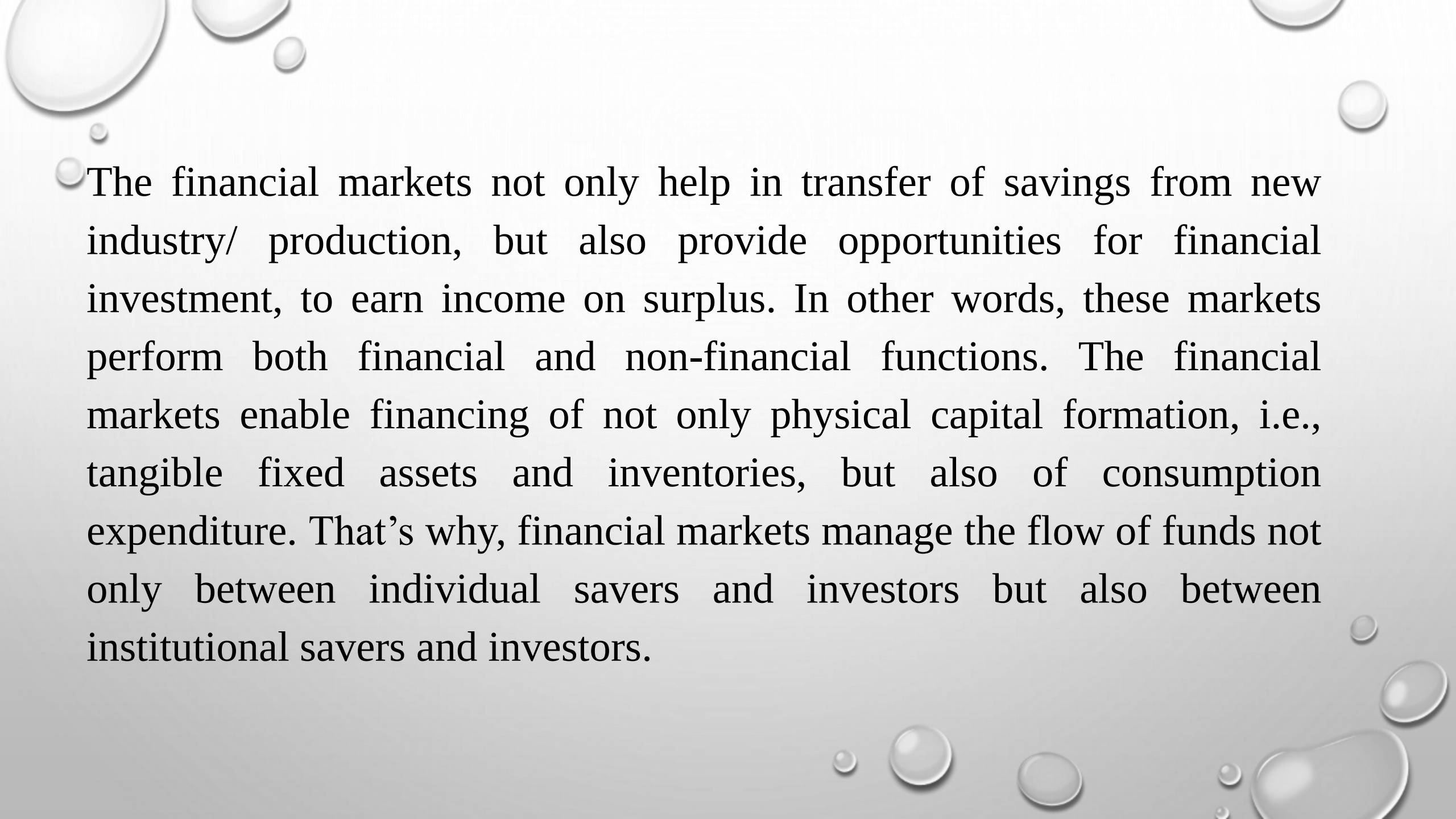




Second, financial markets provide a mechanism for an investor to sell a financial asset. Because of this feature, it is said that a financial market offers liquidity, an attractive feature when circumstances either force or motivate an investor to sell. In the absence of liquidity, the owner will be forced to hold a debt instrument till it matures and an equity instrument till the company is, either voluntarily or otherwise, liquidated. While all financial markets provide some form of liquidity, the degree of liquidity is one of the factors that characterise different markets.



The third economic function of a financial market is that it reduces the search and information costs of transacting. Search costs represent explicit cost, such as the money spent to advertise the desire to sell or purchase a financial asset, the implicit costs such as the value of time spent in locating a counterpart. The presence of some form of organized financial market reduces search costs. Information costs are those entailed with assessing the investment merits of a financial asset, that is, the amount and the likelihood of the cash flow expected to be generated. In an efficient market, prices reflect the aggregate information collected by all market participants.



The financial markets not only help in transfer of savings from new industry/ production, but also provide opportunities for financial investment, to earn income on surplus. In other words, these markets perform both financial and non-financial functions. The financial markets enable financing of not only physical capital formation, i.e., tangible fixed assets and inventories, but also of consumption expenditure. That's why, financial markets manage the flow of funds not only between individual savers and investors but also between institutional savers and investors.

b) Financial Functions

- It provides the borrowers with funds which they need to carry out their plans.
- It provides the lenders with earning assets so that their wealth may be held in a productive form without the necessity of direct ownership of real assets.
- It provides liquidity in the market through which the claims against money can be resold at any time, and thus, reconverting them into current funds.

Financial System

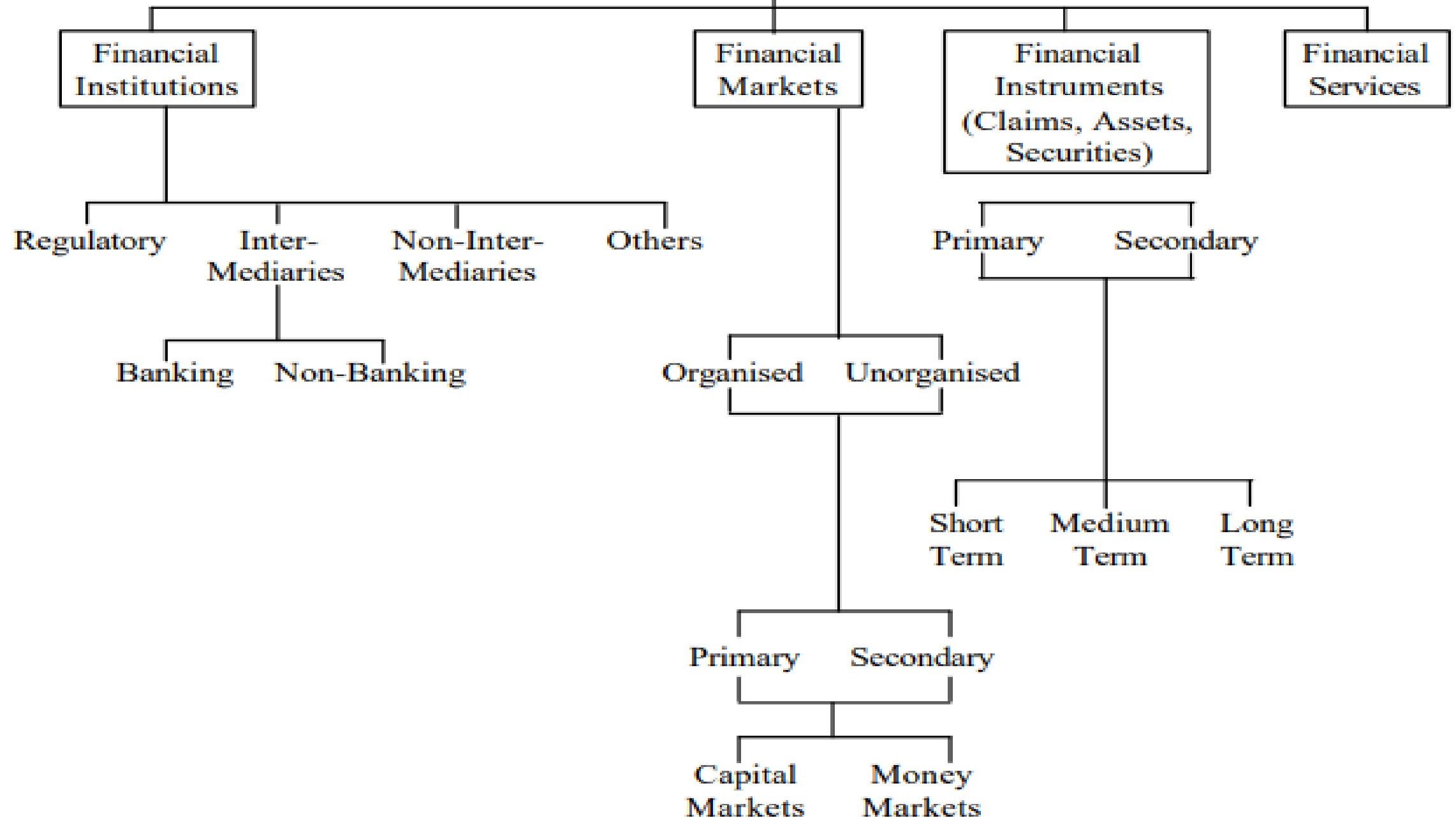


TABLE 2.1 Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository institutions (banks)		
Commercial banks	Deposits	Business and consumer loans, mortgages, U.S. government securities, and municipal bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
Contractual savings institutions		
Life insurance companies	Premiums from policies	Corporate bonds and mortgages
Fire and casualty insurance companies	Premiums from policies	Municipal bonds, corporate bonds and stock, U.S. government securities
Pension funds, government retirement funds	Employer and employee contributions	Corporate bonds and stock
Investment intermediaries		
Finance companies	Commercial paper, stocks, bonds	Consumer and business loans
Mutual funds	Shares	Stocks, bonds
Money market mutual funds	Shares	Money market instruments

Source: Federal Reserve Flow of Funds Accounts: www.federalreserve.gov/releases/Z1/.

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