FINANCIAL MARKET AND SERVICES (KMBFM03)

MBA 3rd Semester

1st Sessional Paper Solution

1. (a.) The term financial system is a set of inter-related activities/services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment capital formation and growth. Van Horne defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that the objective of the financial system is to "supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires." Financial system is the mobilization of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

(b.)

S.No.	Lender	Investor	Borrower
1.	It includes those who can lend his/her excess money which is currently unused.	It includes those who can invest his/her excess money in different securities to generate the high revenue in future.	It includes those who have shortage of money and need some funds to fulfill his/her needs.
2.	It includes those who have right to decide at what return he/she lend his/her money.	It includes those who may or may not have right to decide at what return he/she invest his/her money.	It includes those who don't have right to decide at what rate of interest he/she borrow the money.

(c.) The following are the functions of financial markets:

i. Creation and allocation of credit and liquidity.
ii. Utilization of savings.
iii. Balanced economic growth.
iv. Provide financial convenience.

(d.) Commercial papers are a short-term unsecured loan instrument issued by a corporation typically financing day-to-day operation. It is very safe investment because the financial situation of a company can easily be predicted over a few months. Only company with high credit rating issues commercial papers. This can be issued for longer than 270 days maximum upto one year.

(e.) The following are the needs:

i. Lower search costs.
ii. Spreading risk.
iii. Economies of scale.
iv. Convenience of amounts.

2. (a.) A financial market is a market in which people trade financial securities and derivatives at low transaction costs. Securities include stocks and bonds, and precious metals.The term "market" is sometimes used for what are more strictly exchanges, organizations that facilitate the trade in financial securities, e.g., a stock exchange or commodity exchange. This may be a physical location (such as the NYSE, LSE, JSE, BSE) or an electronic system (such as NASDAQ). Much trading of stocks takes place on an exchange; still, corporate actions (merger, spinoff) are outside an exchange, while any two companies or people, for whatever reason, may agree to sell stock from the one to the other without using an exchange.

Trading of currencies and bonds is largely on a bilateral basis, although some bonds trade on a stock exchange, and people are building electronic systems for these as well, to stock exchanges.

A financial market can be thought of as a location where buyers and sellers meet to exchange goods or services at prices predetermined by supply and demand. The New York Stock Exchange (NYSE) is a great example of a physical financial market that is now a digital financial market too, where stocks are bought and sold at prices determined by supply and demand.

The stock market is a financial market where financing is provided through the issuance, buying, and selling of shares of stock. The stock market is considered a capital market because it provides financing for long-term investments. While there are many specific examples of the stock market, the NYSE example above is the best.

(b.) Commercial banks are called the factories of credit. They advance much more than what the collect from people in the form of deposits. Through the process of credit creation, commercial banks provide finance to all sectors of the economy thus making them more developed than before. In this theory financial system plays a positive role by providing finance or credit through creation of credit in anticipation of savings. The investment is financed through created credit. The basis of credit money is the bank deposits. The bank deposits are of two kinds viz.,

i. Primary deposits, and
ii. Derivative deposits

When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. The power of commercial banks to expand deposits through loans, advances and investments is known as "credit creation."

The banking system as a whole can create credit which is several times more than the original increase in the deposits of a bank. This process is called the multiple-expansion or multiple-creation of credit. Similarly, if there is withdrawal from any one bank, it leads to the process of multiple-contraction of credit. The process of multiple credit-expansion can be illustrated by assuming:

a) The existence of a number of banks, A, B, C etc., each with different sets of depositors.
b) Every bank has to keep 10% of cash reserves, according to law, and
c) A new deposit of ₹ 10,000 has been made with bank A to start with.

Suppose, a person deposits ₹ 10,000 cash in Bank A. As a result, the deposits of bank A increase by ₹ 10,000 and cash also increases by ₹ 10,000. The balance sheet of the bank is as follows:

Balance Sheet of Bank A

Liabilities	Amount (₹)	Assets	Amount (₹)
New Deposit	10,000	New Cash	10,000
Total	10,000	Total	10,000

Suppose bank had given loan to Mr. X.

Under the double entry system, the amount of ₹ 10,000 is shown on both sides.

Balance Sheet of Bank A

Liabilities	Amount (₹)	Assets	Amount (₹)
New Deposit	10,000	New Cash	1,000
		Loan to Mr. X	9,000
Total	10,000	Total	10,000

Suppose X purchase goods of the value of ₹ 9,000 from Y and pay cash.
Y deposits the amount with Bank B.
The deposits of Bank B now increase by ₹ 9,000 and its cash also increases by ₹ 9,000.
After keeping a cash reserve of ₹ 900, Bank B is free to lend the balance of ₹ 8,100 to anyone.
Suppose bank B lends ₹ 8,100 to Z, who uses the amount to pay off his creditors. The balance sheet of bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Amount (₹)	Assets	Amount (₹)
New Deposit	9,000	New Cash	900
		Loan to Mr. Z	8,100
Total	9,000	Total	9,000

Suppose Z purchases goods of the value of ₹ 8,100 from S and pays the amount.
S deposits the amount of ₹ 8,100 in bank C.
Bank C now keeps 10% as reserve (₹ 810) and lends ₹ 7,290 to a merchant.
The balance sheet of bank C will be as follows:

Balance Sheet of Bank C

Liabilities	Amount (₹)	Assets	Amount (₹)
New Deposit	8,100	New Cash	810
		Loan to Merchant	7,290
Total	8,100	Total	8,100

Thus looking at the banking system as a whole, the position will be as follows:

Name of Bank	Deposits (₹)	Cash Reserve (₹)	Loan (₹)
Bank A	10,000	1,000	9,000
Bank B	9,000	900	8,100
Bank C	8,100	810	7,290
Total	27,100	2,710	24,390

(c.) It is a tradable asset which can be in terms of cash, agreement, evidence of an ownership in an entity; or a contractual right which has the right to deliver cash or any kind of asset.
The types of financial instrument used worldwide are as follows:

i. **Deposits:** Deposit in a layman's term, means to save or to keep safely. It can be made either with banking or non-banking firm.
ii. **Stock:** Stocks represents the ownership of the issuing company. It is a form of corporate equity ownership where in the total stock of the company is divided into shares.
iii. **Debts:** Unlike the stocks, financial assets which are in the form of debts create an obligation on the borrower of the fund to repay the amount borrowed. **Example-** Debentures, bonds, etc.

(d.)

Basis for Comparison	Capital Market	Money Market
Definition	Capital market is part of the financial market where lending and borrowing takes place for the medium term and long-term	Money market is part of the financial market where lending and borrowing takes place for short-term up to one year
Types of instruments involved	Capital market deals in equity shares, debentures, bonds, preference shares etc.	Money markets generally deal in promissory notes, bills of exchange, commercial paper, T bills, call money etc.
Institutions involved/types of investors	Capital market involves stockbrokers, mutual funds, underwriters, individual investors, commercial banks, stock exchanges, Insurance Companies	Money market contains financial banks, the central bank, commercial banks, financial Companies, chit funds etc.
Nature of Market	Capital markets are more formal	Money markets are informal
Liquidity of the market	Capital Markets are comparatively less liquid	Money markets are liquid
Maturity period	The maturity of capital markets instruments is longer and they do not have stipulated time frame	The maturity of financial instruments is generally up to 1 year
Risk factor	Due to less liquid nature and long maturity, the risk is comparatively high	Since the market is liquid and the maturity is less than one year, Risk involved is low
Purpose	The capital market fulfills long-term credit needs of the business	The market fulfills short-term credit needs of the business
Functional merit	The capital market stabilises the economy due to long-term savings	The money markets increase the liquidity of funds in the economy
Return on investment	The returns in capital markets are high because of higher duration	The return in money markets are usually low

3 **(a.)** The best portfolio in the boom market is combination of equity because in this market opportunities increases and economy grows that why the share prices also rises.
As a finance manager my suggestion is to create a portfolio with the combination of equity and debt. The reason behind this is if in any situation revenue declines against equity debt manage it.

(b.) Saving as a pre-requisite of investment. It stresses the need for policies to mobilise saving voluntarily for investment and growth. It increases the rate of growth of saving and investment. It makes their composition, allocation, and utilization more optimal and efficient. It activates saving or reduces idle saving. It also reduces unfruitful investment and the cost of transferring saving to investment. Appropriate monetary policy and fiscal policy for promoting and mobilizing savings for investment and growth. Investment is an alternative to consumption. Investment which is not financed by prior savings will generate inflation. This theory does not subscribe to the view that

inflation is needed. This theory favours reasonably positive real interest rates to encourage savings by the public.

How to achieve it:

i. Some people whose current expenditures (expense and investment) are less then their incomes.
ii. Others whose current expenditures (expense and investment) exceeds their current incomes.
iii. It is achieved by ultimate savers and the latter called the ultimate investors.

Income = Savings + Expenditure

4 (a.) Money market is the best suitable market because it is a short-term market and company needs the fund for day-to-day operation.

(b.) Financial liberalization for promoting financial and economic development. **According to McKinnon and Shaw,** the developing countries are characterised by the government interference in the financial system. These countries suffer from poor performance in respect of saving, investment and growth due to financial control, regulation, restrictions by authorities.

Indicators of Financial Restrictions:

i. The existence of indiscriminate distortions in financial prices such as interest rates and exchange rates.
ii. Imposition of interest rates ceiling or fixing nominal interest rates administratively resulting in low or negative real interest rates.
iii. Prescribing high reserve ratios.

Why Financial Liberalization?

The elimination of financial restrictions through financial liberalization, de-regulation, and privatization is essential to eliminate all the ill effects and distortion, and to put developing economies on high saving, high investment, and high growth path**.**

5 (a.) Financial markets are dependent to market failures. There are certain forms of government intervention that will make them function better. The lower interest rates through government improves the average quality of loan applications and improves the efficiency. Lending to those sectors which are usually socially rejected by the market. Conventionally, it is assumed that within any economy, there is a perfect capital mobility and interest rates across regions. In practice market imperfections capital does not flow freely in the market across different regions. This creates a scope for financial market intervention to positively affect regional development by correcting original mis-distribution of capital. The policy can help hereby increasing the direct central and state government investments in local economies.

(b.) Investment is not determined by savings, it is savings which are determined by investment. If the resources are unemployed it would increase investment and savings. If resources are fully employed, it will generate inflation which will lower the real rate of return on financial investments, which will make less attractive to hold and induce holder to invest physical capital. Inflation changes income distribution in favour of profits earner. Inflation imposes tax on real money balances and thereby transfer resources to the Government for financing investment, this known as Inflation Tax Effect.

Limitations and Danger

This concept of forced saving present inflation as a desirable phenomenon, which in real life, people fear inflation. Inflation can induce undesirable pattern of investment. Inflation means greater economic instability and, therefore, greater uncertainty and risk which can discourage investment

activity. Inflation may result in the reduction of exports, lower foreign exchange availability, adverse balance of payments and lower growth. Inflation may increase investment but it may discourage voluntary savings.