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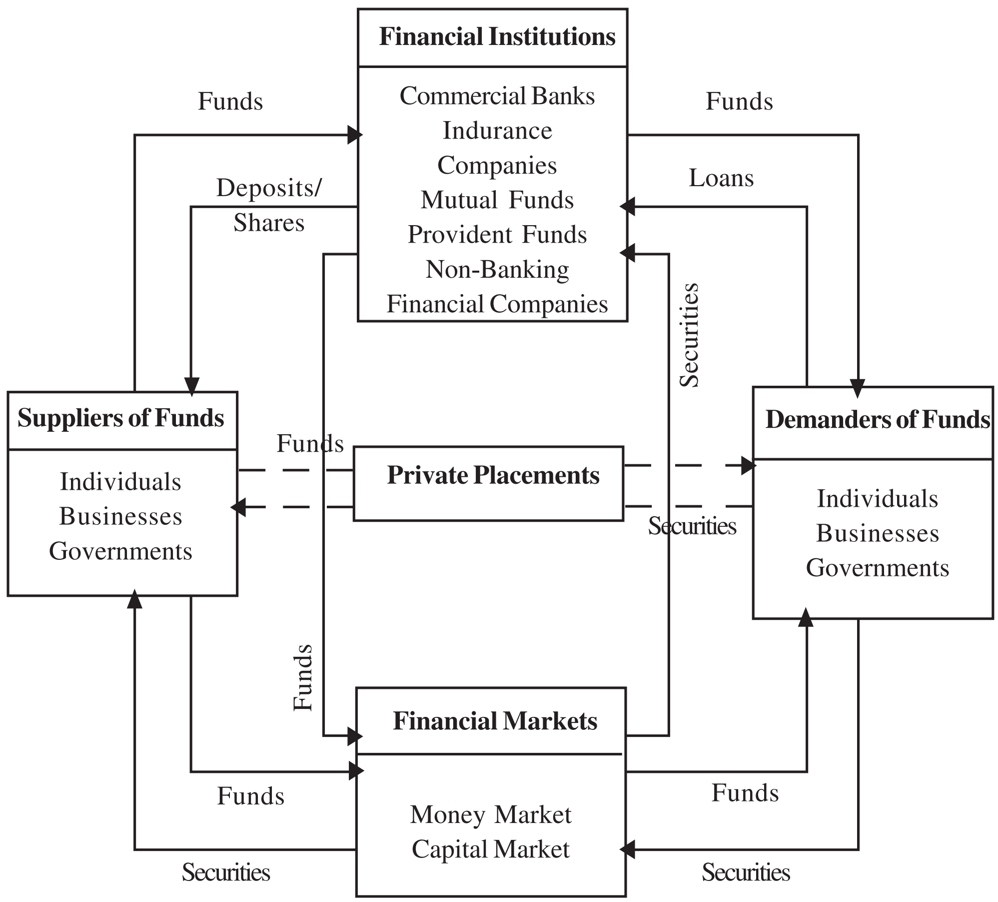
Essay

THE FINANCIAL SYSTEM

The financial system consists of a variety of institutions, markets and instruments that are related in the manner shown in Fig. 1. It provides the principal means by which savings are transformed in to investments.

Fig. 1

The Financial System



1. Financial Instrument

Financial instruments range from the common (coins, currency notes, demand deposits, corporate debentures, gilt-edged securities and equity shres) to the more exotic (futures and options). Financial instruments may be viewed as financial assets and financial liabilities.

Financial assets represent claims against the future income and wealth of others. Financial liabilities, the counterparts of financial assets, represent promises to pay some portion of prospective income and wealth to others. Financial assets and liabilities emanate from the basic process of financing. They distribute the returns and risks of economic activities to a variety of participants. The important financial assets and liabilities, claims and promises to a variety of participants.

Money

Money is issued by the Reserve Bank of India and to a minor extent by the Ministry of Finance.

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Demand Deposit

This is a promise to repay a given sum as and when demanded by the holder. It may or may not carry interest with it.

Short-term Debt

This is a promise to repay a specified sum along with interest within a period of one year.

Intermediate-term Debt

This is a promise to repay a specified sum along with interest within a period that exceeds one year but is less than five Years. Here, the classification of debt into short term, intermediate term, and long term categories on the basis of the period of maturity is quite arbitarary.

Long-term Debt

This is a promise to pay a stream of interest over a long period of time (ordinarily exceeding five years) and then repay the principal in a lumpsum or in instalments. (In exceptional cases the debt may be perpetual.)

Equity Stock

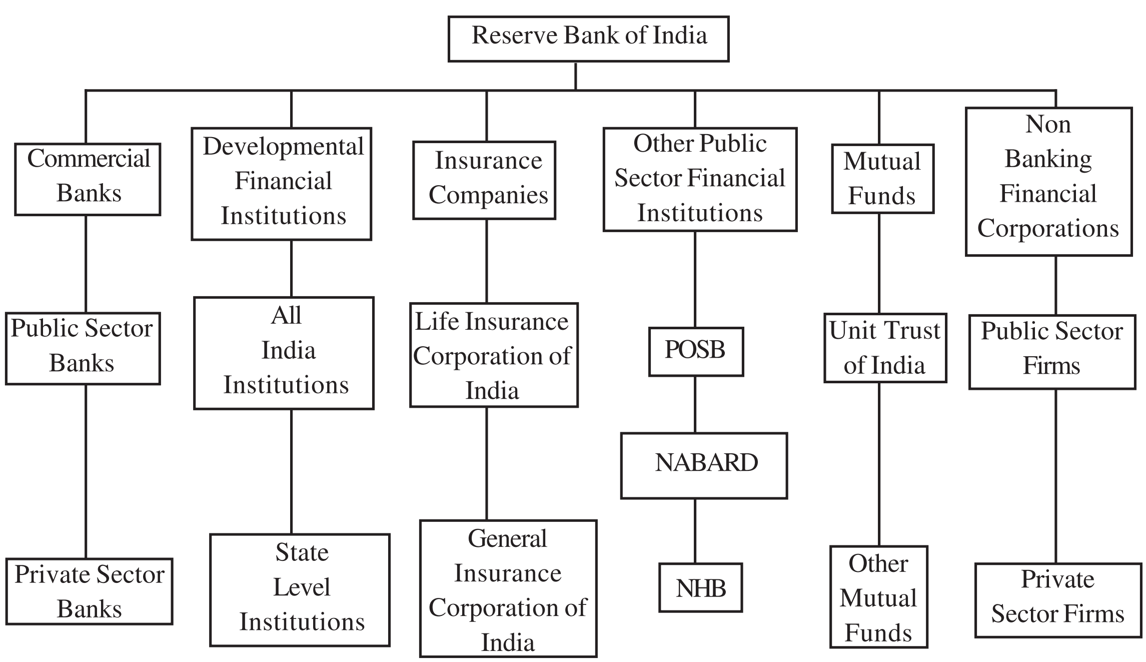
This represents ownership capitla, Equity shareholders ahve a residual interest in the income and wealth of the company after all other calims are fulfilled. In addition to the above, a modern financial system has many other financial contracts like forwards, futures, swaps, options, insurance and so on.

2. Financial Institutions

The primary role of a financial institution is to serve as an intermediary between lenders and borrowers. Financial institutions in the organised sector function under the overall surveillance of the Reserve Bank of India. The structure of financial institutions in India depicted in Fig. 2.

Fig. 2

Structure of Financial Institutions



3. Financial Markets

As against real transactions that involve exchange of money for ral goods or services, a financial transaction involves creation or transfer of a financial asset. Here are some examples of financial transaction involves creation or transfer of a financial asset. Here are some examples of financial transactions: issue of equity stock by a company, purchase of bonds in the secondary market, deposit of money in a bank accont, transfer of funds from a current account to a savings account. While this list can be easily extended, the point of such examples is clear: financial transactions are very pervasive throughout the economic system. Hence financial markets, which exist wherever finanacial transactions occur, are equally ervasive.

There are two broad segments of the financial market, viz., the money market and the capital market. The money market deals with short-term debt, whereas the capitla market deals with long-term debt and stock (equity and preference). Further, each of these markets has a primary segment and a secondary segment. New financial assets are issued in the primary market, whereas outstanding financial assets are traded in the secondary segment.

Money Market

The money market deals in short-term debt in contrast to the capital market which deals in long-term debt and stock (equity and preference). The money market in India, as in many other developing countries, is dechotomised into the organised and unorganised segments. The principal interemdiaries in the organised segment are the commercial and other banks. (In addition, there are the LIC, UTI, discount and Finance House of India Ltd., mutual funds, non-banking financial companies, and cooperative societies which presently play a minor role.) These intermediaries lend funds on a short-term basis to create an active inter-bank call loan market as part of the organised money market.

Capital Market

The capital market is the market for financial assets that have long or indefinite maturity. When a company wishes to raise capital by issuing securities, it goes to the primary market which is the segment of the copital market where issuers exchange financial securities for long-term funds. The primary market facilitates the formation of capitla.

There are three ways in which a company may raise capital in the primary market: public issue, rights issue, and private placement. Public issue, which involves sale of securities to members of the public, is the most important mode of raising long-term funds. Rights issue is the method of raising further capital from existing shareholders by offering additional securities privately to a small group of investors.

The secondary market in India, where outstanding securities are traded, consists of the stock exchanges recognised by the government. There are presently twenty one regional exchanges (located at Mumbai, Calcutta, Delhi, Chennai and other cities) and two nation -wide computerised exchanges, viz., the National Stock Exchange (NSE) and the Over- The-Counter Exchange of India (OTCEI).

The government has accorded powers to the Securities and Exchange Board of India (SEBI) , an autonomous body, to oversee the functioning of the securities market and the operations of intermediaries like mutual funds and merchant bankers and to prohibit insider trading.