On Financial Markets: Some Musings

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Abstract

A financial market, any marketplace or system in which buyers and sellers participate in the trade of financial securities, is an integral part of any nation's economy. After giving an overview of the market, the paper delves into some of its core facets, focusing on market efficiency and the impact of monetary policy in the Indian context.

Keywords: Financial market, Monetary policy, Market efficiency.
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Introduction

The financial sector is described as 'the brain of the economy' by Stiglitz (1998). Within this sector are housed two financial markets – the money market and the capital market. Money market is basically a market for short term funds, short term money and short term financial assets which are easily convertible into money. In other words, it is a market in which funds are borrowed and lent for a short period. The borrowers are the traders and speculators, brokers, government and other institutions. The lenders are the commercial banks, other financial institutions, insurance companies and the central bank of the country (who is the lender of the last resort). Crowther (1958) says that the money market is "the collective name given to the various firms and institutions that deal in the various grades of the near-money." The utility of the money market lies in the fact that it meets the short term needs of the borrower and simultaneously provides lenders with a liquid asset.
The broad objectives of the money market are to provide:

1. An equilibrating mechanism for smoothening short term deficits and surpluses;
2. A focal point of central bank intervention for influencing liquidity in the economy; and
3. A reasonable access to the users of short term funds to meet their requirements at realistic price or cost.

Capital market refers to the market for long term fund. It may be divided into two parts: Primary market and Secondary market. The primary market is basically the market for new issues of capital, i.e., a new issue market. It does not have physical existence, nor does it have any administrative organization. On the other hand, secondary market is a market for existing issues, i.e., the stock exchanges. This has both physical existence and proper administrative organization.

Despite the differences, the two markets have close links. First, both primary and secondary markets are basically parts of one market, i.e. the industrial securities market. So, they are prone to be influenced by some common factors and are mutually dependent. When there is a boom in the securities' prices in the stock exchanges, business houses tend to float a large number of new issues in the market.

Introduction

When there is a slump in the securities' prices in the secondary market, new issues are hardly floated. Secondly, the securities listed on the recognized stock exchanges must have been issued in the new issue market prior to their arrival in the secondary market. Thirdly, the organization of new issues is, to a great extent, controlled by the stock exchanges. Regulations relating to dealing in securities have provisions that new issues seeking stock exchange listing must be bound by statutory rules and regulations of stock exchange so that fair dealings in them are ensured.

The fundamental difference between money market and capital market, as it transpires from above, is that the former deals with short term funds and the latter, with long term funds. There is however, a close relation between the two. First the money market and the capital market are mutually dependent. For example, a relative rise in the interest rate in the money market may cause an increase in demand in the capital market. On the other side of the coin, a relative increase in the returns in the capital market will cause increased demand in the money market. Secondly, a number of institutions operating in the money market also operate in the capital market. Instance can be drawn from the case of Indian commercial banks which provide both long term and short term funds. Thirdly, the capital market is dependent upon the money market for finance. This is particularly true for the secondary market.

Market Efficiency – Risk & Return

As both money market and capital market are parts of the industrial securities market, let us turn to the efficiency of the securities market. In the last few decades, the term 'market efficiency' *[Samuelson (1965), Fama (1970), Fama (1991)]* has been construed as the state where the future risk and return associated with alternative securities is reflected accurately in the market prices. Modern portfolio theory is based on the relationship between expected return and risk. Different levels of expected returns on investment in securities are offered by different markets. Even in the same market, different levels of expected return crop up at different points of time. The total expected return on the portfolio of an investor comprises two elements – the risk-free return and the risk premium. Risk-free return is the return on riskless securities like treasury bills. 'Risk premium' is the additional return, over and above the risk-free return, expected by the investors because of their investing in risky securities. So, the expected returns move up with the increasing risk because of the increase in the risk premium. From this point of view, we come out with the fact that the efficiency of the securities market is not characterized by the exclusion of risks, but is dependent on the accuracy with which the incorporated risks are reflected in the prices of securities.

Impact of Monetary Policy

Monetary Policy represents policies, objectives and instruments which are directed towards the regulation of money supply and the cost and availability of credit in the economy [Balachandran (1998)]. The objectives of the monetary policy and the intermediate targets chosen to attain those objectives play great roles towards formulating and conducting the monetary policy [Rangarajan (1997)]. Thus, there can be said to be three tiers in the structure of monetary policy. The first tier is to decide on the ultimate objectives of monetary policy; the second tier is to fix some intermediate targets and the last tier is to formulate an operating framework of policy instruments towards achieving the ultimate objective through the intermediary targets.

Impact of Monetary Policy

In India, a conclusive form of monetary policy structure in the pre-reform era was founded on the recommendations made by the Chakravarty Committee.[1] Two core objectives of monetary policy, as considered by the Committee, were maintenance of price stability and provision of sufficient credit to the productive sectors of the economy.

Since the early 1990s, the policy environment, along with structure and strategies, has undergone certain major changes. This is based on the recommendations of the Working Group on Money Market, 1987 and the Narasimham Committee I, 1991.[2] The course of monetary and banking sectors' reforms in the areas of structural reforms, prudential regulation and deregulation of financial markets in the major part of the 1990s were guided by the policy structure suggested by the Narasimham Committee I as also by the Narasimham Committee II, 1997 on Banking Sector Reforms. These changes have paved the way for market forces to play a broader role by providing the Reserve Bank of India the much required space in the implementation of its monetary policy.

Reviews, in relation to both effectiveness and the part played by the instruments of monetary policy, are made continuously. Recently RBI has started to depend more on indirect instruments such as Open Market Operations, Bank Rate, Repo, etc. This differs from the previous practice of placing greater reliance solely on cash reserve ratio.

Liberalisation has the import of *inter alia,* higher incidence of volatility in financial markets. The RBI has accordingly modified its operating strategies to suit such cases. The RBI now undertakes short term measures like Repo rates, Bank Rate, Cash Reserve Ratio, etc., to obtain stability in money market as well as in foreign exchange market.

ENDNOTES:

[1] Committee to Review the Working of the Monetary System, 1985.

[2] Committee on the Financial System, 1991.

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