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B.Com Honours

Semester I

Calicut University

Basics of Financial Markets

Course Code: COM1MN105 • Module 2 Notes

1. Classification of Financial Markets

Financial markets represent the channels through which financial assets are created, bought, and sold. They allocate capital across sectors based on liquidity, risk appetite, and investment horizons. This module covers the broad classification of financial markets, the detailed features and significance of the money market, money market instruments in India, and the structural defects of the Indian money market.

Structure of Financial Markets

Financial markets are classified on several bases:

By Tenure (Maturity)

- **Money Market:** Deals in short-term debt instruments with maturities up to one year (high liquidity, low risk).
- **Capital Market:** Deals in long-term debt and equity instruments with maturities exceeding one year.

By Stage of Issue

- **Primary Market:** The market for new securities (IPOs, FPOs) where companies raise capital directly.
- **Secondary Market:** The market for trading existing securities (Stock Exchanges) providing liquidity to investors.

By Security Type

- **Equity Market:** Market for trading shares representing ownership in companies.
- **Debt Market:** Market for trading fixed-income instruments like bonds and debentures.

2. The Money Market: Features and Significance

The money market is a wholesale market for short-term debt instruments. It provides a mechanism for financial institutions, corporations, and governments to manage short-term liquidity deficits or surpluses.

Key Features of the Money Market

- **Short-Term Focus:** Deals in instruments with maturities ranging from overnight to one year.
- **Over-the-Counter (OTC) Dominance:** Most transactions are conducted electronically or telephonically between institutional participants rather than on formal exchanges.
- **High Liquidity & Low Risk:** Instruments are highly liquid and carry minimal default risk as participants are typically highly rated banks, corporations, and governments.
- **Wholesale Market:** Transaction sizes are very large, meaning retail investors participate primarily through mutual funds (Liquid Funds).

Significance of the Money Market

The money market helps commercial banks park temporary surpluses to earn interest, provides the central bank (RBI) with a channel to execute monetary policy (repo rates), and allows corporations to secure cheap working capital.

3. Money Market Instruments in India

The Indian money market features several standardized short-term debt instruments:

Instrument	Issuer	Maturity Period	Core Features
Treasury Bills (T-Bills)	RBI (on behalf of Government of India).	91 days, 182 days, 364 days.	Issued at a discount and redeemed at par (zero-coupon). Carry zero default risk.
Commercial Paper (CP)	Highly rated large corporations.	7 days to 1 year.	Unsecured promissory notes issued to meet short-term working capital needs.
Certificate of Deposit (CD)	Commercial Banks & Financial Institutions.	7 days to 1 year (banks).	Negotiable, dematerialized receipts for funds deposited in a bank.
Call / Notice Money	Interbank market (commercial banks).	1 day (Call), 2 to 14 days (Notice).	Used by banks to manage daily cash reserves (CRR/SLR requirements).
Repo / Reverse Repo	RBI and Commercial Banks.	Typically overnight.	Repurchase agreements where securities are sold with a promise to buy back at a set rate.

4. Defects of the Indian Money Market

Despite significant reforms, the Indian money market suffers from several structural defects:

- **Dichotomy (Dual Structure):** Existence of an organized market (regulated by RBI) alongside a large unorganized market (indigenous bankers, money lenders) that charges high interest rates.
- **Lack of Integration:** Interest rates in different segments of the money market (call money, commercial bills) do not always move in coordination.
- **Underdeveloped Bill Market:** Commercial bill usage is very low in India, as businesses prefer cash credit and overdraft facilities.
- **Interest Rate Volatility:** Call money rates experience sharp fluctuations during periods of tight liquidity (e.g., tax payment cycles).

- **Limited Retail Access:** High minimum investment requirements keep retail savers out of primary money market instruments.

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