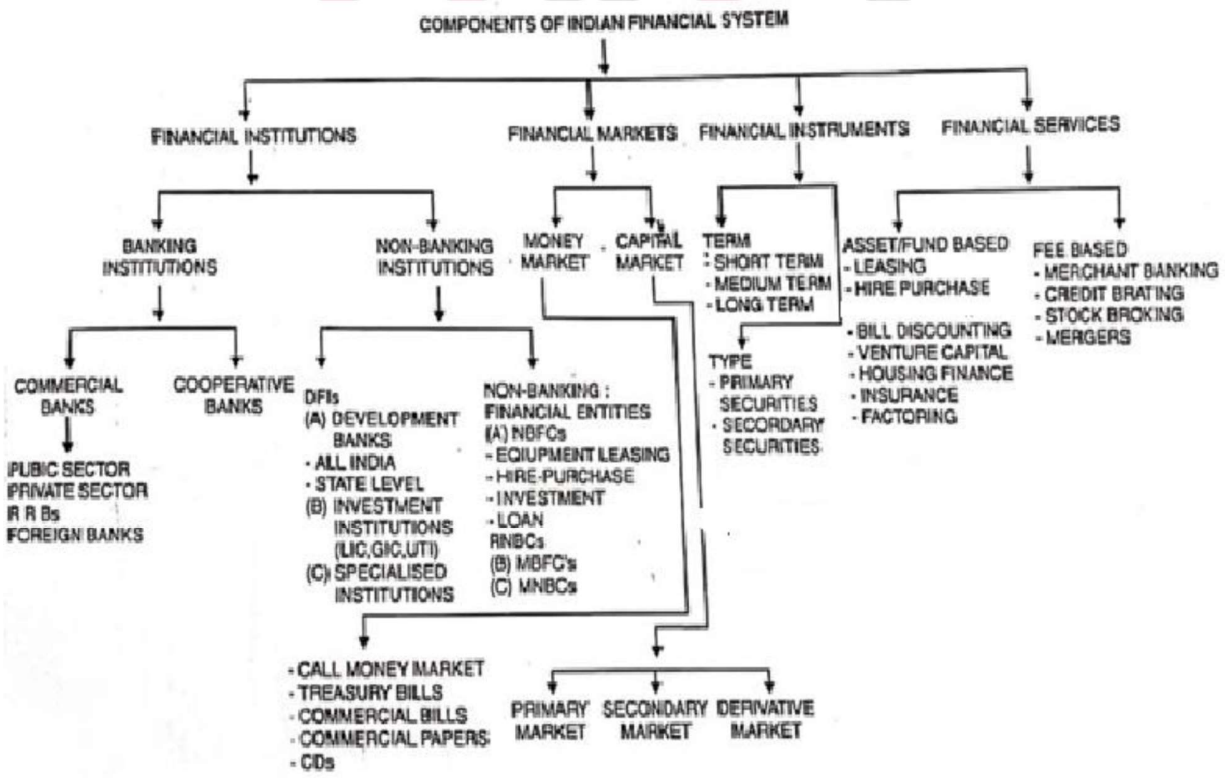
Notes

Unit 1: Indian Financial System

1.1 Introduction

Financial System is a set of institutional arrangements through which financial surpluses in the economy are mobilized from surplus units and transferred to deficit spenders.

1.2 Structure of Indian Financial system



The basic structure of Indian Financial System is divided into four components which are:

1. Financial Institutions
2. Financial Markets
3. Financial Instruments
4. Financial Services

1.3 Financial Institutions – Regulatory, Intermediaries, Non- Intermediaries

I. Financial Institutions – Regulatory

The Indian financial system is regulated by five major regulatory bodies, they are:

1. RBI as an apex monetary institution:
Established in April, 1935 in Calcutta, the Reserve Bank of India (RBI) later moved to Mumbai in 1937. After its nationalization in 1949, RBI is presently owned by the Govt. of India. It has 19 regional offices, majorly in state capitals, and 9 sub-offices. It is the issuer of the Indian Rupee. RBI regulates the banking and financial system of the country by issuing broad guidelines and instructions.

Role of RBI
Control money supply.
Monitor key indicators like GDP and inflation.
Maintain people's confidence in the banking and financial system by providing tools such as 'Ombudsman'.
Formulate monetary policies such as inflation control, bank credit and interest rate control.

2. SEBI as a regulatory body for the securities market:
Securities Exchange Board of India (SEBI) was established in 1988 but got legal status in 1992 to regulate the functions of securities market to keep a check on malpractices and protect the investors. Headquartered in Mumbai, SEBI has its regional offices in New Delhi, Kolkata, Chennai and Ahmedabad.

Role of SEBI
Protect the interests of investors through proper education and guidance
Regulate and control the business on stock exchanges and other security markets
Stop fraud in capital market
Audit the performance of stock market

3. Insurance Regulatory and Development Authority of India (IRDAI)
IRDAI is an autonomous apex statutory body for regulating and developing the insurance industry in India. It was established in 1999 through an act passed by the Indian Parliament. Headquartered in Hyderabad, Telangana, IRDA regulates and promotes insurance business in India.

4. Forward Market Commission of India (FMC)
Headquartered in Mumbai, FMC is a regulatory authority governed by the Ministry of Finance, Govt. of India. It is a statutory body, established in 1953 under the Forward Contracts (Regulation) Act, 1952. The commission allows commodity trading in 22 exchanges in India. The FMC is now merged with SEBI.

5. Pension Fund Regulatory and Development Authority (PFRDA)
Established in October 2003 by the Government of India, PFRDA develops and regulates the pension sector in India. The National Pension System (NPS) was launched in January 2004 with an aim to provide retirement income to all the citizens. The objective of NPS is to set up pension reforms and inculcate the habit of saving for retirement amongst the citizens.

II. Financial Intermediaries

When it comes to financial intermediaries, there is a long list of those who qualify. Often times, people may not even realize that they are interacting with a middlemen who is just overseeing the transaction in question. Nevertheless, without these entities, the investment markets would be crippled and unable to operate.
A financial intermediary is an institution which connects the deficit and the surplus. The best example of an intermediary can be a bank which transforms the bank deposits to bank loans. The role of financial intermediary is to channel funds from people who have extra inflow of money i.e., the savers to those who do not have enough money to full fill the needs or to carry out the basic activities i.e. the borrowers.

Functions of Financial Intermediaries
Functions of Financial Intermediary are basically classified in three parts which are as follows:
1. **Maturity transformation** – Deals with the conversion of short-term liabilities to long term assets.
2. **Risk transformation** – Conversion of risky investments into relatively risk-free ones.
3. **Convenience denomination** – Way of making the unmatched matching which is matching small deposits with large loans and large deposits with small loans.

1. Commercial Banks:

A commercial bank is a kind of financial institution which carries all the operations related to deposit and withdrawal of money for the general public, providing loans for investment, etc. These banks are profit-making institutions and do business only to make a profit.
The two primary characteristics of a commercial bank are lending and borrowing. The bank receives the deposits and gives money to various projects to earn interest (profit). The rate of interest that a bank offers to the depositors are known as the borrowing rate, while the rate at which banks lends the money is called the lending rate.

Functions of Commercial Bank:

The functions of commercial banks are classified into two main division.

(a) Primary functions –

- **Accepts deposit –** The bank takes deposits in the form of saving, current, and fixed deposits. The surplus balances collected from the firm and individuals are lent to the temporary required of commercial transactions.
- **Provides Loan and Advances –** Another critical function of this bank is to offer loans and advances to the entrepreneurs and business people and collect interest. For every bank, it is the primary source of making profits. In this process, a bank retains a small number of deposits as a reserve and offers (lends) the remaining amount to the borrowers in demand loans, overdraft, cash credit, and short-run loans etc.
- **Credit Cash-** When a customer is provided with credit or loan, they are not provided with liquid cash. First, a bank account is opened for the customer and then the money is transferred to the account. This process allows a bank to create money.

(b) Secondary functions –

- **Discounting bills of exchange –** It is a written agreement acknowledging the amount of money to be paid against the goods purchased at a given point of time in future. The amount can also be cleared before the quoted time through a discounting method of a commercial bank.
- **Overdraft Facility –** It is an advance given to a customer by keeping the current account to overdraw up to the given limit.
- **Purchasing and Selling of the Securities –** The bank offers you with the facility of selling and buying the securities.
- **Locker Facilities –** Bank provides lockers facility to the customers to keep their valuable belonging or documents safely. Banks charge a minimum of an annual fee for this service.
- **Paying and Gather the Credit –** It uses different instruments like a promissory note, cheques, and bill of exchange.

Types of Commercial Bank:

There are three different types of commercial bank.

- **Private Bank –** It is one type of commercial banks where private individuals and businesses own a majority of the share capital. All private banks are recorded as companies with limited liability. For example, Bank of Baroda, State Bank of India (SBI), Dena Bank, Corporation Bank, and Punjab National Bank.
- **Public Bank –** It is those type of bank that is nationalized, and the government holds a significant stake. Such as Housing Development Finance Corporation (HDFC) Bank, Industrial Credit and Investment Corporation of India (ICICI) Bank, and Vysya Bank etc.
- **Foreign Bank –** These banks are established in foreign countries and have branches in other countries. For instance, American Express Bank, Hong Kong and Shanghai Banking Corporation (HSBC), Standard & Chartered Bank, and Citibank etc.

2. **Cooperative Banks:**

- The cooperative banking structure is the oldest segment of the Indian banking system.
- Cooperative Bank is the district feature of the co-operative credit structure in the Indian banking system
- Cooperative banks CATER to the financial needs of agriculture, retail tree, small industries, self-employed, urban, semi-urban, rural areas.

Cooperative Banks fall under the Cooperative Societies Act which is regulated by the RBI and are governed by the Banking Regulations Act 1949 and Banking Laws (Cooperative Societies) Act, 1965. It is originated in India with the enactment of the Co-operative Credit Societies Act of 1904. The Anyoya Cooperative Bank was the first Co-operative Bank in Asia.

Structure of cooperative banks in India:
It is 3-Pillars structure (Pyramid Structure)

- SCB – State Cooperative Bank
- DCCB – District Central Cooperative Bank
- PACS – Primary Agriculture credit services (There should be 10 members in PACS)

State Cooperative banks:
It is a federation of central Co-operative bank and acts as a watchdog. They obtain their funds from share capital, deposits, loans and overdrafts from the Reserve Bank of India and can lend money to central co-operative banks and primary societies and not directly to the farmers.

District Central Cooperative Bank
These are the federations of primary credit societies in a district and are of two types-those having a membership of primary societies only and those having a membership of societies as well as individuals. The funds of the bank consist of share capital, deposits, loans and overdrafts from state co-operative banks and joint stocks. These banks provide finance to member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint stock bank

Primary Agriculture credit services
The primary cooperative credit society is an association of borrowers and non-borrowers residing in a locality. The funds of the society are derived from the share capital and deposits of members and loans from central cooperative banks. The borrowing powers of the members as well as of the society are fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, etc

The members of the cooperative bank:

1. Are of similar occupation or profession
2. Must have common membership
3. Must reside within the same geographical area

Objectives of Cooperative banks:

1. Engage in rural financing and micro-financing
2. To remove the dominance of the common man by the middleman and money lenders
3. Ensure credit services to farmers at the low rate of interest providing the socioeconomic condition to the people
4. Provide financial support for the needy people and farmers in the rural areas
5. Provides personal financial services for those engaged in small-scale industries and self-employment driven activities for people in both rural and urban areas.

Difference between Co-operative banks & Commercial banks:

Cooperative Bank	Commercial Bank
Federal Structure in nature, i.e. at the top level State Co-operative Banks and at the village level primary Co-operative Credit Societies.	They are functioning on the branch banking & the branches are located in all areas of rural, urban, etc., the head office contains branches through Zonal Office.
They are generally concentrating on rural credit & provide credit facilities to agricultural & rural activities.	They are mainly concentrating on the requirements of trade & industry.
In co-operative Bank the borrowers are usually their members.	Borrowers can be any including individual institutions.
The Co-operative Banks provide a little higher rate of interest on deposits as compared to commercial banks.	The Commercial Banks provide a lesser rate of interest as compared to co-operative banks.

Functions of Cooperative Banks in India: cooperative banks functions

1. They function with the rule of "one member, one vote" and function on "no profit, no loss" basis
2. It performs all the main banking functions of deposit mobilization, the supply of credit and provision of remittance facilities
3. It provides financial assistance to the people with small means to protect them from the debt trap of the moneylenders
4. It is engaged in tasks of production, processing, marketing, distribution, servicing and banking in India
5. It supervises and guides affiliated societies
6. Mobilization of funds from their members

7. Advance loans to the members
8. Rural financing for farming, cattle, milk, hatchery, personal finance, etc.
9. Urban financing for Self – employment, Industries Small scale units, Home finance, Consumer finance, Personal finance.

III. Non- Intermediaries

Non- Banking Financial Markets.

The most important difference between non-banking financial companies and banks is that NBFCs don't take demand deposits. A non-banking financial institution (NBFI) or non-bank financial company (NBFC) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFI facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and market brokering. Examples of these include insurance firms, pawn shops, cashier's check issuers, check cashing locations, payday lending, currency exchanges, and microloan organizations. Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment which act as backup facilities should the primary form of intermediation fail."

1.4 Financial Markets

Financial Market is a mechanism that allows people to indulge themselves in the buying and selling i.e. trade of financial securities (for example stocks and bonds), commodities (for example precious metals) at prices that reflect the market's effectiveness.

Following are the verticals of financial market:

1. Capital Market – Market where business enterprises or government entities raise fund for long term using the weapon of securities or debts. It includes the Stock market (equities) and Bond Market (debt) for fund raising.

2. Commodity Market – Commodity is a good for which there is a demand by the people thus commodity market is the market where such goods are traded.

3. Money Market – Deals with the assets involved in short-term borrowing and lending with original maturities ranging from a period of one year or even lesser time frames.

4. Derivative Market – The derivative market is the financial market meant for derivatives. The financial instruments like the futures contracts or options, which are derived from other forms of assets, are traded in these markets.

5. Insurance Market – Deals with the trading of insurance policies.

6. Futures Market – A vertical in financial market where people can trade standardized futures contracts which is a contract to buy specific number of quantities of a commodity or financial instrument at a specified price with the delivery of the commodity or financial instrument set at a specified time in the future**.**

7. Foreign Exchange Market – Also known as Forex is a global, worldwide decentralized financial market meant only for the trading of currencies.

1.5 Financial Instruments

Financial Instrument is a trade-able 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 in the form deposits, stock, and debt.

1. **Deposits** – Deposit in a layman's term, means to save or to keep safely. Deposits can be made either with banking or non-banking firm.

2. 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 and the individuals has the provision to trade the shares in the exchange.

3. **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. The debt instrument, thus in a sense, is a contract entered into by the borrower and the lender which specifies the amount of fund borrowed, period of borrow, the rate of interest that will be charged and the repayment methods.

1.6 Financial Services

As the name suggests **financial services** are the services provided by the Financial Institutions. These services generally include the *banking services, Foreign exchange services, investment services, insurance services* and few others. Following is a very brief description of the services

1. **Banking Services** – Includes all the operations provided by the banks including to the simple deposit and withdrawal of money to the issue of loans, credit cards etc.

2. **Foreign Exchange services** – this includes the currency exchange, foreign exchange banking or the wire transfer.

3. **Investment Services** – It generally includes the asset management, hedge fund management and the custody services

4. **Insurance Services** – It deals with the selling of insurance policies, brokerages, insurance underwriting or the reinsurance

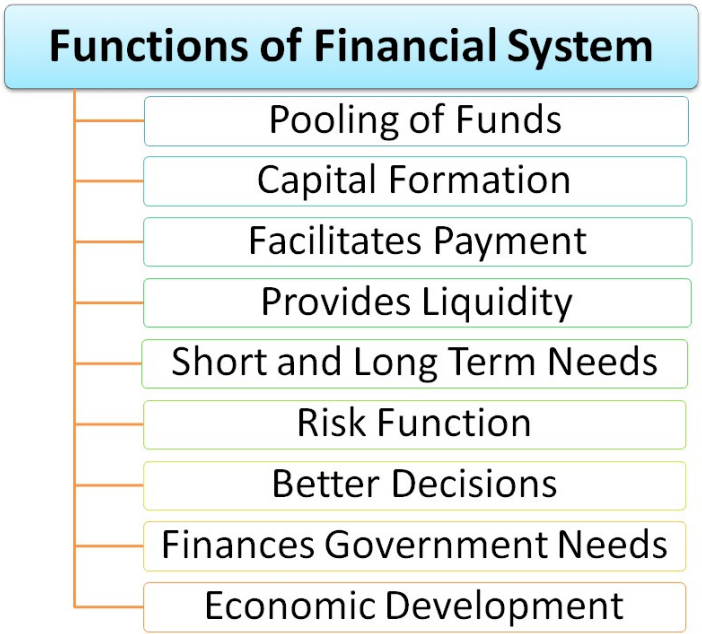
5. Some of the other services include the advisory services, venture capital, angel investment etc.

1.7 Indicators of Financial Development

a) Finance Ratio (FR)
b) Financial Inter-relation Ratio (FIR)
c) New Issue Ratio (NIR)
d) Intermediation Ratio (IR)
e) The Ratio of Money to National Income
f) The proportion of current account deficit which is financial by market related flows
g) Developed Financial Sector is fully integrated
h) Transaction Cost and Information Cost
i) Predominance of Private Banking
j) Good Management
k) Developed Financial Structure

l) Openness of the Economy
m) Effective and Quick Enforcement
n) Well-Developed Secondary Markets
o) Indirect Techniques of Monetary Policy

1.8 Roles of Financial System in Economic Development



Unit 2: Indian Money Market

2.1 Introduction

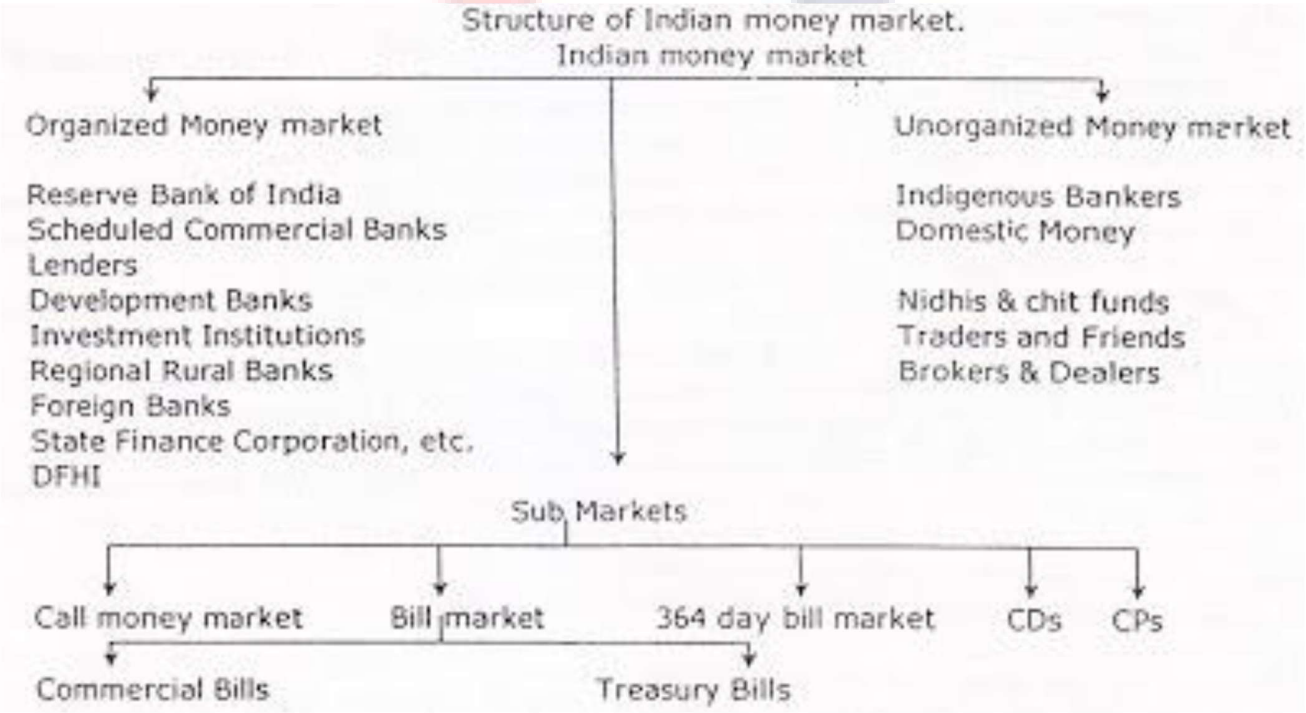
The Money Market is a market for lending and borrowing of short-term funds. It deals in funds and financial instruments having a maturity period of one day to one year. It covers money and financial assets that are close substitutes for money. The instruments in the money market are of short-term nature and highly liquid.

- As per RBI definitions ―A market for short terms financial assets that are close substitute for money, facilitates the exchange of money in primary and secondary market‖.
- The money market is a mechanism that deals with the lending and borrowing of short-term funds (less than one year).
- It doesn't actually deal in cash or money but deals with substitute of cash like trade bills, promissory notes & govt papers which can convert into cash without any loss at low transaction cost.
- It includes all individual, institution and intermediaries.

2.2 Structure or components of Indian money market.

The Indian money market consists of two segments,

1. Organized sector
2. Unorganized sector.



The RBI is the most important constituents of Indian money market. The organized sector is within the direct purview of RBI regulation. The unorganized sector comprises of indigenous bankers, money lenders and unregulated non-banking financial institutions. The structure or components of Indian money market is depicted the following:

(A) Organised Sector

1. Call and Notice Money Market:

Under call money market, funds are transacted on overnight basis. Under notice money market funds are transacted for the period between 2 days and 14 days. The funds lent in the notice money market do not have a specified repayment date when the deal is made. The lender issues a notice to the borrower 2-3 days before the funds are to be paid. On receipt of this notice, the borrower will have to repay the funds within the given time. Generally, banks rely on the call money market where they raise funds for a single day. The main participants in the call money market are commercial banks (excluding RRBs), cooperative banks and primary dealers. Discount and Finance House of India (DFHI), Non-banking financial institutions such as LIC, GIC, UTI, NABARD etc. are allowed to participate in the call money market as lenders.

2. Treasury Bills (T-Bills):

Treasury bills are short-term securities issued by RBI on behalf of Government of India. They are the main instruments of short term borrowing by the Government. They are useful in managing short-term liquidity. At present, the Government of India issues three types of treasury bills through auctions, namely – 91 days, 182-day and 364-day treasury bills. There are no treasury bills issued by state governments. With the introduction of the auction system, interest rates on all types of TBs are being determined by the market forces.

3. Commercial Bills:

Commercial bill is a short-term, negotiable, and self-liquidating instrument with low risk. They are negotiable instruments drawn by a seller on the buyer for the value of goods delivered by him. Such bills are called trade bills. When trade bills are accepted by commercial banks, they are called commercial bills. If the seller gives some time for payment, the bill is payable at future date (i.e. usance bill). Generally, the maturity period is up to 90 days. During the usance period, if the seller is in need of funds, he may approach his bank for discounting the bill. Commercial banks can provide credit to customers by discounting commercial bills. The banks can rediscount the commercial bills any number of times during the usance period of bill and get money.

4. Certificates of Deposits (CDs):

CDs are unsecured, negotiable promissory notes issued at a discount to the face value. They are issued by commercial banks and development financial institutions. CDs are marketable receipts of funds deposited in a bank for a fixed period at a specified rate of interest. CDs were introduced in India in June 1989. The main purpose of the scheme was to enable commercial banks to raise funds from the market

through CDs. According to the original scheme, CDs were issued in multiples of Rs.25 lakh subject to minimum size of an issue being Rs.1 crore. They had the maturity period of 3 months to one year. They are freely transferable but only after the lock in period of 45 days after the date of issue.

5. Commercial Papers (CPs):

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note with fixed maturity. They indicate the short-term obligation of an issuer. They are quite safe and highly liquid. They are generally issued by the leading, nationally reputed, highly rates and credit worthy large manufacturing and finance companies is the public as well as private sector. CPs were introduced in India January 1990. CPs were launched in India with a view to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and also to provide an additional instrument to investors. RBI has modified its original scheme in order to widen the market for CPs. Corporates and primary dealers (PDs) and the all India financial institutions can issue CPs. A corporate can issue CPs provided they fulfil the following conditions: (a) The tangible net worth of the company is not less than Rs.4 crore. (b) The company has been sanctioned working capital limit by banks or all India financial institutions, and (c) The borrowed account of the company is classified as a standard asset by the financing institution or bank.

6. Repos:

A repo or reverse repo is a transaction in which two parties agree to sell and repurchase the same security. Under repo, the seller gets immediate funds by selling specified securities with an agreement to repurchase the same at a mutually decided future date and price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller at an agreed date and price. The repos in government securities were first introduced in India since December 1992. Since November 1996, RBI has introduced ―Reverse Repos‖, i.e. to sell government securities through auction.

7. Discount and Finance House of India (DFHI):

It was set up by RBI in April 1988 with the objective of deepening and activating money market. It is jointly owned by RBI, public sector banks and all India financial institutions which have contributed to its paid-up capital. The DFHI deals in treasury bills, commercial bills, CDs, CPs, short-term deposits, call money market and government securities. The presence of DFHI as an intermediary in the money market has helped the corporate entities, banks, and financial institutions to invest their short-term surpluses in money market instruments.

8. Money Market Mutual Funds (MMMFs):

RBI introduced MMMFs in April 1992 to enable small investors to participate in the money market. MMMFs mobilizes savings from small investors and invest them in short-term debt instruments or money market instruments such as call money, repos, treasury bills, CDs and CPs. These instruments are forms of debt that mature in less than a year.

(B) Unorganised Sector

The unorganized Indian money market is largely made up of indigenous bankers, money lenders and unregulated non-bank financial intermediaries. They do operate in urban centres but their activities are largely confined to the rural sector. This market is unorganized because its activities are not systematically coordinated by the RBI. The main components of unorganized money market are:

1. Indigenous Bankers:

They are financial intermediaries which operate as banks, receive deposits and give loans and deals in hundies. The hundi is a short-term credit instrument. It is the indigenous bill of exchange. The rate of interest differs from one market to another and from one bank to another. They do not depend on deposits entirely; they may use their own funds.

2. Money Lenders:

They are those whose primary business is money lending. Money lenders predominate in villages. However, they are also found in urban areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The borrowers are generally agricultural labourers, marginal and small farmers, artisans, factory workers, small traders, etc.

3. Unregulated non-bank Financial Intermediaries:

The consist of Chit Funds, Nithis, Loan companies and others. (a) Chit Funds: They are saving institutions. The members make regular contribution to the fund. The collected funds is given to some member based on previously agreed criterion (by bids or by draws). Chit Fund is more famous in Kerala and Tamilnadu. (b) Nidhis: They deal with members and act as mutual benefit funds. The deposits from the members are the major source of funds and they make loans to members at reasonable rate of interest for the purposes like house construction or repairs. They are highly localized and peculiar to South India. Both chit funds and Nidhis are unregulated.

4. Finance Brokers:

They are found in all major urban markets specially in cloth markets, grain markets and commodity markets. They are middlemen between lenders and borrowers.

2.3 Functions of Money Market:

1. To maintain monetary balance between demand and supply of short term monetary transactions.
2. Money market plays a very important role of making funds available to many units or entities engaged in diversified field of activities be it agriculture, industry, trade, commerce or any other business.
3. By providing funds to developing sectors it helps in growth of economy also.
4. Another important feature that money market provides is discounting of bills of exchange which facilitates growth of trade.
5. No doubt it provides a base for the implementation of monetary policy also.

6. The money market provides opportunity for short term investments, which provide for short term savings, which in turn help formation of capital base also.

2.4 Characteristics of Money Market

1. It is a market purely for short-terms funds or financial assets called near money.
2. It deals with financial assets having a maturity period less than one year only.
3. In Money Market transaction cannot take place formal like stock exchange, only through oral communication, relevant document and written communication transaction can be done.
4. Transaction have to be conducted without the help of brokers.
5. It is not a single homogeneous market, it comprises of several submarket like call money market, acceptance & bill market.
6. The component of Money Market are the commercial banks, acceptance houses & NBFC (Non-banking financial companies).

2.5 Features of Money Market

1. Existence of Unorganized Money Market:

This is one of the major defects of Indian money market. It does not distinguish between short term and long-term finance, and also between the purposes of finance. Since it is outside the control and supervision of RBI, it limits the RBI's control of over money market.

2. Lack of Integration:

The Indian money market is broadly divided into two sectors, the organized money market and the unorganized market. The organized market constitutes several institutions such as RBI, State Bank of India, commercial banks, cooperative banks and financial institutions. RBI as an apex body regulates their working. The unregulated sector is not homogenous in itself. It constitutes indigenous bankers, loan companies, money lenders, etc. There is no uniformity in their practices and there is multiplicity of functionaries.

3. Multiplicity in Interest Rates:

There exist too many rates of interest in the Indian money market such as the borrowing rate of government, deposits and lending rates of cooperative and commercial banks, lending rates of financial institutions, etc. This is due to lack of mobility of funds from one section of the money market to another. The rates differ for funds of same durations lent by different institutions.

4. Inadequate Funds:

Generally, there is shortage of funds in Indian money market on account of various factors like inadequate banking facilities, low savings, lack of banking habits, existence of parallel economy, etc. However, the banking development particularly branch expansion, has improved the mobilization of funds to some extent in the recent years.

5. Seasonal Stringency of Money:
The seasonal stringency of money and high rate of interest during the busy season (November to June) is a striking feature of Indian money market. There are wide fluctuations in the interest rates from one season to another. RBI has been taking various measures to avoid such fluctuations in the money market by adding money into the money market during the busy season and withdrawing the funds during the slack season.

6. Absence of Bill Market:
A well-organized bill market is necessary for linking up various credit agencies effectively to RBI. The bill market is not yet developed on account of many factors such as the practice of banks keeping a large amount of cash for liquidity purposes, preference for borrowing rather than discounting bills, dependence of indigenous bankers on one another, widespread practice of using cash credit, high stamp duty on usance bill, etc.

7. Inadequate Credit Instruments:
The Indian money market did not have adequate short-term paper instruments till 1985-86. There were only call money and bill markets. Moreover, there were no specialist dealers and brokers dealing in the money market. After 1985-86, RBI has introduced new credit instruments such as 182-day treasury bills, 364-day treasury bills, CDs and CPs. These instruments are still in underdeveloped state in India. The above defects of Indian money market clearly indicate that it is relatively less developed and has yet to acquire sufficient depth and width. Thus, it cannot be compared with developed money markets such as London and New York money markets.

2.6 Instrument of Money Market
A variety of instrument are available in a developed money market. In India till 1986, only a few instruments were available They were:
- Treasury bills
- Commercial papers.
- Certificate of deposit.
- Call Money Market
- Commercial bills market

Treasury Bills (T-Bills)
- Treasury bills (TBs), offer short-term investment opportunities, generally up to one year.
- They are thus useful in managing short-term liquidity.
- Types of treasury bills through auctions
- 91- Day, 182- day, 364- day, and 14- day TBs

Commercial paper (CP)

 CP is a short-term unsecured loan issued by a corporation typically financing day to day operation.
 CP 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 CP's.

Certificates of Deposit

 Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Usance Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period
 Scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs)
 Select all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

Call Money Market

 Call money market is that part of the national money market where the day to day surplus funds, mostly of banks are traded in.
 They are highly liquid, their liquidity being exceed only by cash.
 The loans made in this market are of the short-term nature.

Commercial Bills Market

 Funds for working capital required by commerce and industry are mainly provided by banks through cash credits, overdrafts, and purchase/discontinuing of commercial bills.

Bill of Exchange

 The financial instrument which is traded in the bill market of exchange. It is used for financing a transaction in goods that takes some time to complete.

2.7 Participants in Money Market

 Central Government
 State Government
 Public Sector Undertakings
 Scheduled Commercial Banks (SCBs)
 Private Sector Companies
 Provident Funds
 General Insurance Companies
 Life Insurance Companies
 Mutual Funds
 Non-banking Finance Companies

2.8 Reforms of Money Market

The Committee to Review the Working of Monetary System chaired by S. Chakravarty made several recommendations in 1985 to develop Indian money market. As a follow-up, the RBI set up a Working Group on money market under the chairmanship of N. Vaghul, in 1987. Based on the recommendations of Vaghul Committee, RBI initiated a number of measures to widen and deepen the money market. The main measures are as follows.

1. Deregulation of Interest Rates:

From May 1989, the ceiling on interest rates on the call money, inter-bank short-term deposits, bills rediscounting and inter-bank participation was removed and the rates were permitted to be determined by the market forces. Thus, the system of administered interest rates is being gradually dismantled.

2. Introduction of New Money Market Instruments:

In order to widen and diversify the Indian money market RBI has introduced many new money market instruments such as 182-days treasury bills, 364-day treasury bills, CDs & CPs. Through these instruments the government, commercial banks, financial institutions and corporate can raise funds through the money market. They also provide investors additional instruments for investments. In order to expand the investor base for CDs and CPs the minimum amount of investment and the minimum maturity periods are reduced by RBI.

3. Repurchase Agreements (Repos):

RBI introduced repos in government securities in December 1992 and reverse repos in November 1996. Repos and reverse repos help to even out short-term fluctuations in liquidity in the money market. They also provide a short-term avenue to banks to park their surplus funds. Through changes in repo and reverse repo rates RBI transmits policy objectives to entire money market.

4. Liquidity Adjustment Facility (LAF):

RBI has introduced LAF from June 2000 as an important tool for adjusting liquidity through repos and reverse repos. Thus, in the recent years RBI is using repos and reverse repos as a policy to adjust liquidity in the money market and therefore, to stabilize the short-term interest rates or call rates. LAF has, therefore, emerged as a major instrument of monetary policy.

5. Money Market Mutual Funds (MMMF):

RBI introduced MMMFs in April 1992 to enable the individual investors to participate in money market. To make the scheme flexible and attractive, RBI has brought about many modifications. The important features of this scheme as of now are: (i) It can be set up by commercial banks, financial institutions and private sector. (ii) Individual investors, corporates and others can invest in MMMFs. (iii) Resources mobilized through this scheme can be invested in money market instruments as well as rated corporate bonds and debentures with a maturity period up to one year. (iv) The minimum lock in period is now 15 days.

6. **Discount and Finance House of India (DFHI)**:
In order to impart liquidity to money market instruments and help the development of secondary market in such instruments, DFHI was set up in 1988 jointly by RBI, public sector banks and financial institutions.

7. Development of Inter-bank Call and Notice Money Market:
The call and notice money market are an inter-bank market the world over and therefore the Narsimham Committee has recommended that we adopt the same in India. However, RBI in the past had given permission to non-bank institutions to participate in the call money market as lenders. As per the recommendations of Narsimham Committee RBI in 2001-02 has underlined the need for transforming the call money market into a pure inter-bank money market.

8. Regulation of NBFCs:
The RBI Act was amended in 1997 to provide for a comprehensive regulation of NBFC sector. According to the amendment, no NFBC can carry on any business of a financial institution, including acceptance of public deposit, without obtaining a Certificate of Registration (CoR) from RBI.

9. The Clearing Corporation of India Limited (CCIL):
The CCIL was registered on April 30, 2001 under the Companies Act, 1956, with the State Bank of India as the chief promoter. The CCIL clears all transactions in government securities and repos reported on the Negotiated Dealing System (NDS) of RBI.

Unit 3: Indian Capital Market

3.1 Introduction

Capital market is the market for medium and long-term funds. It refers to all the facilities and the institutional arrangements for borrowing and lending term funds (medium-term and long-term funds). The demand for long-term funds comes mainly from industry, trade, agriculture and government. The central and state governments invest not only on economic overheads such as transport, irrigation, and power supply but also a basic and consumer goods industry and hence require large sums from capital market. The supply of funds comes largely from individual savers, corporate savings, banks, insurance companies, specialized financial institutions and government.

Meaning:

Capital market is a market where buyers and sellers engage in trade of financial securities like bonds, stocks, etc. The buying/selling is undertaken by participants such as individuals and institutions.

Definition:

According to Arun K. Datta, the capital market may be defined as "The capital market is a complex of institutions investment and practices with established links between the demand for and supply of different types of capital gains".

According to F. Livingston defined the capital market as "In a developing economy, it is the business of the capital market to facilitate the main stream of command over capital to the point of the highest yield. By doing so it enables control over resources to pass into hands of those who can employ them most effectively thereby increasing productive capacity and spelling the national dividend".

3.2 Interrelations between Money and Capital Markets

The money market and capital market are closely interrelated because most corporations and financial institutions are active in both. Firms may borrow funds from the money market for a short period or for a loan period from the capital market. A number of factors may prompt borrowers and lenders to resort to either the money market or the capital market which reflect the interdependence of the two markets.

They are discussed below:

1. Lenders may choose to direct their funds to either or both markets depending on the availability of funds, the rates of return, and their investment policies.
2. Borrowers may obtain their funds from either or both markets according to their requirements. A firm may borrow short-term funds by selling commercial paper or it may float additional shares or bonds.
3. Some corporations and financial institutions serve both markets by buying and selling short-term and long-term securities.
4. All long-term securities become short-term instruments at the time of maturity. So some capital market instruments also become money market instruments.

5. Funds flow back and forth between the two markets whenever the treasury finances maturing bills with treasury securities or whenever a bank lends the proceeds of a maturing loan to a firm on a short-term basis.
6. Yields in the money market are related to those of the capital market. A fall in the short-term interest rates in the money market shows a condition of essay credit which is likely to be followed or accompanied by a more moderate fall in the long-term interest rates in the capital market. However, money market interest rates are more sensitive than are long-term interest rates in the capital market.

Distinction between Money and Capital Markets:
1. The money market deals in short-term funds which are used for financing current business operations and short-term needs of the government. On the other hand, the capital market deals in long-term funds required by industry and government.
2. Short-term funds in the money market refer to a period of less than a year, while in the capital market long-term funds refer to a period up to 25 years.
3. The money market uses such instruments as promissory notes, bills of exchange, treasury bills, certificates of deposits, commercial papers, etc. On the other hand, the capital market uses long-term securities such as shares, debentures and bonds of industrial concerns, and bonds and securities of the government.
4. The institutions operating in the money market and the capital market also differ from each other. The central bank, commercial banks, non-bank financial intermediaries and bill brokers deal in money market instruments. On the other hand, stock exchanges, mutual funds, leasing companies, investment banks, investment trusts, insurance companies, etc. dealing capital market instrument.

3.3 Characteristics of Indian Capital Market

Long Term Investment

Capital market is a market for trading of long term securities. Long term investment avenues are provided by it to the investors. Borrowers may raise fund for a long period in the capital market. Here lending and borrowing is for a period that is more than one year. Long term financial instruments such as stocks, bonds, and debentures are traded in the capital market.

Link Between Borrowers and Lender

Capital market is a link between borrower and Lander. It links the person having the surplus Fund with the one who has a shortage of fund. The capital market provides different investment avenues in which the person can invest. This help in providing borrowers with long term funds by bringing large investments from peoples.

Capital Formation

Capital market's actions determine the rate of capital formation in a market. Capital market offers attractive opportunities to people who have surplus funds so that they invest more and more in the capital market and are invited to save more for profitable opportunities. This way it accelerates the rate of capital formation in the economy.

Accurate Timely Information

Capital market provides accurate information to the investors. The information must be provided timely. So that investor can make the decision of investment Whether to invest in a company or not.

Includes Primary Market and Secondary Market

Capital market of two types of primary market and secondary market. The primary market is concerned with the issue of new securities. Here securities are issued for the first time. Secondary market is concerned with the existing securities. Securities already traded is traded secondary market.

Government Regulations

The capital market works but under the advice of government policies. These markets operate within the framework of regulations and government rules, for example, the stock exchange works under the regulations of SEBI (Securities Exchange Board of India) which is a government body.

Provides Liquidity

As the instruments may be convertible into cash in the capital market. As per the need, of the investor can convert their investment into the liquid form. This is how capital markets provide liquidity.

Variety of Instruments

Capital market has a variety of instrument. Some instruments are at high risk and some instruments are low risk. this instrument can be debentures, Equity shares preferential Shares. As per the risk-taking ability of an investor can choose Between in these instruments.

3.4 Functions of Capital Market:

- It acts in linking investors and savers
- Facilitates the movement of capital to be used more profitability and productively to boost the national income
- Boosts economic growth
- Mobilization of savings to finance long term investment
- Facilitates trading of securities
- Minimization of transaction and information cost
- Encourages a massive range of ownership of productive assets
- Quick valuations of financial instruments
- Through derivative trading, it offers insurance against market or price threats
- Facilitates transaction settlement
- Improvement in the effectiveness of capital allocation
- Continuous availability of funds

3.5 Significance of Capital Market in economic development.

Capital market has a crucial significance to capital formation. Adequate capital formation is indispensable for a speedy economic development. The main function of capital market is the collection of savings and their distribution for industrial development. This stimulates capital formation and hence, accelerates the process of economic development. A sound and efficient capital market facilitates the process of capital formation and thus contributes to economic development. The significance of capital market in economic development is explained below.

1. **Mobilization of Savings**: Capital market is an organized institutional network of financial organizations, which not only mobilizes savings through various instruments but also channelizes them into productive avenues. By making available various types of financial assets, the capital market encourages savings. By providing liquidity to these financial assets through the secondary markets capital market is able to mobilize large amount of savings from various sections of the people such as individuals, families, and associations. Thus, capital market mobilizes these savings and make the same available for meeting the large capital needs of industry, trade and business.

2. **Channelization of Funds into Investments**: Capital market plays a crucial role in the economic development by channelizing funds in accordance with development priorities. The financial intermediaries in the capital market are better placed than individuals to channel the funds into investments which are more favourable for economic development.

3. **Industrial Development**: Capital market contributes to industrial development in the following ways: (a) It provides adequate, cheap and diversified finance to the industrial sector for various purposes. (b) It provides funds for diversified purposes such as for expansion, modernization, upgradation of technology, establishment of new units etc. (c) It provides a variety of services to entrepreneurs such as

provision of underwriting facilities, participating in equity capital, credit rating, consultancy services, etc. This helps to stimulate industrial entrepreneurship.

4. **Modernization and Rehabilitation of Industries**: Capital market can contribute towards modernization, rationalization and rehabilitation of industries. For example, the setting up of development financial institutions in India such as IFCI, ICICI, IDBI and so on has helped the existing industries in the country to adopt modernization and replacement of obsolete machinery by providing adequate finance.

5. **Technical Assistance**: An important bottleneck faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to the preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in the capital market play an important role in stimulating industrial entrepreneurship. This helps to stimulate industrial investment and thus promotes economic development.

6. **Encourage Investors to invest in Industrial Securities**: Secondary market in securities encourage investors to invest in industrial securities by making them liquid. It provides facilities for continuous, regular and ready buying and selling of securities. Thus, industries are able to raise substantial amount of funds from various segments of the economy.

7. **Reliable Guide to Performance**: The capital market serves as a reliable guide to the performance and financial position of corporate, and thereby promotes efficiency. It values companies accurately and toes up manager compensation to stock values. This gives incentives to managers to maximize the value of companies. This stimulates efficient resource allocation and growth.

3.6 Deficiencies in The Indian Capital Market

The Indian capital market suffers from the following deficiencies:

- Lack of diversity in the financial instruments.
- Lack of control over the fair disclosure of financial information.
- Poor growth in the secondary market.
- Prevalence of insider trading and front running.[1]
- Manipulation of security prices.
- Existence of unofficial trade in the primary market, prior to the issue coming into the market.
- Absence of proper control over brokers and sub-brokers.
- Passive role of public financial institutions in checking malpractices.
- High cost of transactions and intermediation, mainly due to the absence of well-defined norms for institutional investment.

3.7 Participants of Capital Market

1 Bombay Stock Exchange

Bombay Stock Exchange is the oldest stock exchange in India as well as Asia. It is an integral component of the "$1 trillion" club, having the 11th largest market capitalisation value at $2.2 trillion. **BSE stock exchange** was founded by Premchand Roychand in 1875 and is currently managed by Sethurathnam Ravi, serving as the chairman.

2 National Stock Exchange (NSE)

The National Stock Exchange of India Ltd. (NSE) is an Indian stock exchange located at Mumbai, Maharashtra, India. National Stock Exchange (NSE) was established in 1992 as a demutualized electronic exchange. It was promoted by leading financial institutions on request of the Government of India. It is India's largest exchange by turnover. In 1994, it launched electronic screen-based trading. Thereafter, it went on to launch index futures and internet trading in 2000, which were the first of its kind in the country. Mr. Vikram Limaye is the MD and CEO of NSE.

3 Over the Counter Exchange of India (OTCEI)

The OTC Exchange Of India (OTCEI), also known as the Over-the-Counter Exchange of India, is based in Mumbai, Maharashtra. It is India's first exchange for small companies, as well as the first screen-based nationwide stock exchange in India. OTCEI was set up to access high-technology enterprising promoters in raising finance for new product development in a cost-effective manner and to provide a transparent and efficient trading system to investors.

OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India, and other institutions, and is a recognised stock exchange under the SCR Act.

The OTC Exchange Of India was founded in 1990 under the Companies Act 1956 and was recognized by the Securities Contracts Regulation Act, 1956 as a stock exchange. The OTCEI is no longer a functional exchange as the same has been de-recognised by SEBI vide its order dated 31 Mar 2015.

3.8 Types of Capital Market

- **Primary Market:** The primary market mainly deals with new securities that are issued in the stock market for the first time. Thus, it is also known as the new issue market. The main function of the primary market is to facilitate the transfer of the newly issued shared from the companies to the public. The main investors in this type of market are financial institutions, banks, HNIs, etc.
- **Secondary Market:** It is the market where the trading of the securities actually takes place, thus it is also referred to as the stock market. Here the buying and selling of securities take place, the existing investors sell the securities and new investors by the securities.

3.9 Instruments of Indian Capital Market

Instruments in capital markets can be classified into three categories: Pure, Hybrid and Derivatives.

(1) Pure Instruments: Equity shares, preference shares, debentures and bonds which are issued with the basic characteristics without mixing the features of other instruments are called pure instrument.

(2) Hybrid Instruments: Instruments which are created by combining the features of equity, preference, bond are called as hybrid instruments. Example: Hybrid instruments are: -

Convertible preference shares
- Non-convertible debentures with equity warrant
- Partly convertible debentures
- Secured premium notes

(3) Derivative Instrument: A derivative instrument is a financial instrument which derives its value from the value of some other financial instrument or variable.

Example: Futures and Options belong to the categories of derivatives.

3.10 Reforms in Capital Market

The reforms in the capital market are explained below with respect to primary and capital markets in India.

Primary Market Reforms

A number of measures has been taken in India especially since 1991 to develop primary market in India. These measures are discussed below:

1**. Abolition of Controller of Capital Issues**: The Capital Issues (Control) Act, 1947 governed capital issues in India. The capital issues control was administered by the Controller of Capital Issues (CCI). The Narasimham Committee (1991) had recommended the abolition of CCI and wanted SEBI to protect investors and take over the regulatory function of CCI. Thus, government replaced the Capital Issues (Control) Act and abolished the post of CCI. Companies are allowed to approach the capital market without prior government permission subject to getting their offer documents cleared by SEBI.

2. **Securities and Exchange Board of India (SEBI**): SEBI was set up as a non-statutory body in 1988 and was made a statutory body in January 1992. SEBI has introduced various guidelines for capital issues in the primary market. They are explained below.

3. **Disclosure Standards**: Companies are required to disclose all material facts and specific risk factors associated with their projects. SEBI has also introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.

4. **Freedom of Determine the Par Value of Shares**: The requirement to issue shares at a par value of Rs.10 and Rs.100 was withdrawn. SEBI has allowed the companies to determine the par value of shares issued by them. SEBI has allowed issues of IPOs through ―book building‖ process.

5. **Underwriting Optional**: To reduce the cost of issue, underwriting by the issuer is made optional. It is subject to the condition that if an issue was not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected would be refunded to the investors.

6. **FIIs Permitted to Operate in the Indian Market**: Foreign institutional investors such as mutual funds and pension funds are allowed to invest in equity shares as well as in debt market, including dated government securities and treasury bills.

7. Accessing Global Funds Market: Indian companies are allowed to aces global finance market and benefit from the lower cost of funds. They have been permitted to raise resources through issue of American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Indian companies can list their securities on foreign stock exchanges through ADR./GDR issues.

8. Intermediaries under the Purview of SEBI: Merchant bankers, and other intermediaries such as mutual funds including UTI, portfolio managers, registrars to an issue, share transfer agents, underwriters, debenture trustees, bankers to an issue, custodian of securities, and venture capital funds have been brought under the purview of SEBI.

9**. Credit Rating Agencies**: Various credit rating agencies such as Credit Rating Information Services of India Ltd. (CRISIL – 1988), Investment Information and Credit Rating Agency of India Ltd. (ICRA – 1991). Cost Analysis and Research Ltd. (CARE – 1993) and so on were set up to meet the emerging needs of capital market.

Secondary Market Reforms

A number of measures have been taken by the government and SEBI for the growth of secondary capital market in India. The important reforms or measures are explained below.

1. **Setting up of National Stock Exchange (NSE):** NSE was set up in November 1992 and started its operations in 1994. It is sponsored by the IDBI and co-sponsored by other development finance institutions, LIC, GIC, Commercial banks and other financial institutions.

2**. Over the Counter Exchange of India (OTCEI):** It was set in 1992. It was promoted by a consortium of leading financial institutions of India including UTI, ICICI, IDBI, IFCI, LIC and others. It is an electronic national stock exchange listing an entirely new set of companies which will not be listed on other stock exchanges.

3**. Disclosure and Investor Protection (DIP) Guidelines for New Issues**: In order to remove inadequacies and systematic deficiencies, to protect the interests of investors and for the orderly growth and development of the securities market, the SEBI has put in place DIP guidelines to govern the new

issue activities. Companies issuing capital in the primary market are now required to disclose all material facts and specify risk factors with their projects.

4**. Screen Based Trading:** The Indian stock exchanges were modernized in the 90s, with Computerised Screen Based Trading System (SBTS). It electronically matches orders on a strict price / time priority. It cuts down time, cost, risk of error and fraud, and therefore leads to improved operational efficiency.

5. Depository System: A major reform in the Indian Stock Market has been the introduction of depository system and scripless trading mechanism since 1996. Before this, the trading system was based on physical transfer of securities. A depository is an organization which holds the securities of shareholders in electronic form, transfers securities between account holders, facilitates transfer of ownership without handling securities and facilitates their safekeeping.

6. Rolling Settlement: Rolling settlement is an important measure to enhance the efficiency and integrity of the securities market. Under rolling settlement all trades executed on a trading day are settled after certain days.

7**. The National Securities Clearing Corporation Ltd. (NSCL):** The NSCL was set up in 1996. It has started guaranteeing all trades in NSE since July 1996. The NSCL is responsible for post-trade activities of the NSE. Clearing and settlement of trades and risk management are its central functions.

8. Trading in Central Government Securities: In order to encourage wider participation of all classes of investors, including retail investors, across the country, trading in government securities has been introduced from January 2003. Trading in government securities can be carried out through a nationwide, anonymous, order-driver, screen-based trading system of stock exchanges in the same way in which trading takes place in equities.

9. Mutual Funds: Emergency of diversified mutual funds is one of the most important development of Indian capital market. Their main function is to mobilize the savings of general public and invest them in stock market securities. Mutual funds are an important avenue through which households participate in the securities market.

Unit 4: Foreign Exchange Market

4.1 Meaning, Segments, Participants in Foreign Exchange Market

4.1.1 Meaning and Need for Foreign Exchange

Meaning of Foreign Exchange

Foreign exchange, or forex, is the conversion of one country's currency into another. In a free economy, a country's currency is valued according to the laws of supply and demand. In other words, a currency's value can be pegged to another country's currency, such as the U.S. dollar, or even to a basket of currencies.1 A country's currency value may also be set by the country's government.

However, many countries float their currencies freely against those of other countries, which keeps them in constant fluctuation.

According to section 2(b) of the Foreign Exchange Regulation Act, 1973, "foreign exchange" means foreign currency and includes—

(i) all deposits, credits and balances payable in any foreign currency and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency;

(ii) any instrument payable, at the option of the drawee or holder thereof or any other party thereto, either in Indian currency or in foreign currency or partly in one and partly in the other.

Need for Foreign Exchange

1. Trade Requirements
2. Requirements of other Transactions
3. Capital Transactions
4. Credit Transactions
5. Remittances
6. Third Country Currencies

4.1.2 Foreign Exchange Market: Meaning

The foreign exchange market (also known as forex, FX or the currency market) is an over-the-counter (OTC) global marketplace that determines the exchange rate for currencies around the world. Participants are able to buy, sell, exchange and speculate on currencies. Foreign exchange markets are made up of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers and investors.

Characteristics of the Foreign Exchange Market

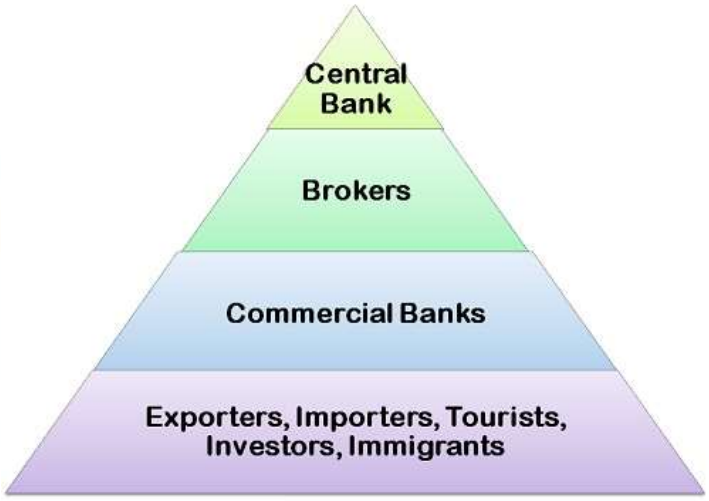
To understand what a forex market is, we must first go through its essential features.

Discussed below are the various characteristics of the foreign exchange market which differentiates it from other financial markets:

- **Market Transparency**: It is effortless to monitor the fluctuations in the value of currencies of different countries in a forex market easily through account tracking and real-time portfolio, without the involvement of brokers.
- **Dollar is Extensively Traded Currency**: The USD, which is paired with almost every country's currency and listed on the forex, is the most widely traded currency in the world.
- **Most Dynamic Market**: The value of the currencies in the forex market keeps on changing every second and function twenty-four hours a day. This makes it one of the most active markets in the world.
- **International Network of Dealers**: The foreign exchange market establishes a medium among the dealers and also with the customers. There are dealer's institutions located globally to carry out the exchange and trading activities.
- **"Over-The-Counter" Market**: In different countries, the forex market is the highly unregulated market initiating over the counter trade by the banks through telex and telephone.
- **High Liquidity**: The currency is considered to be the most widely traded financial instrument across the globe, making the forex market highly liquid.
- **Twenty-Four Hour Market**: The foreign exchange market is operational for twenty-four hours of the day, initiating the active trade and exchange of currencies at any time.

4.1.3 Structure of foreign Exchange Market

The structure of the foreign exchange market constitutes central banks, commercial banks, brokers, exporters and importers, immigrants, investors, tourists. These are the main players of the foreign market, their position and place are shown in the figure below.



At the bottom of a pyramid are the actual buyers and sellers of the foreign currencies- exporters, importers, tourist, investors, and immigrants. They are actual users of the currencies and approach **commercial banks** to buy it.

The ***commercial banks*** are the second most important organ of the foreign exchange market. The banks dealing in foreign exchange play a role of **"market makers",** in the sense that they quote on a daily basis the foreign exchange rates for buying and selling of the foreign currencies. Also, they function as **clearing houses**, thereby helping in wiping out the difference between the demand for and the supply of currencies. These banks buy the currencies from the **brokers** and sell it to the buyers.

The third layer of a pyramid constitutes the ***foreign exchange brokers***. These brokers function as a link between the central bank and the commercial banks and also between the actual buyers and commercial banks. They are the major source of market information. These are the persons who do not themselves buy the foreign currency, but rather strike a deal between the buyer and the seller on a commission basis.

The ***central bank*** of any country is the apex body in the organization of the exchange market. They work as the **lender of the last resort** and the **custodian of foreign exchange of the country**. The central bank has the power to regulate and control the foreign exchange market so as to assure that it works in the orderly fashion. One of the major functions of the central bank is to prevent the aggressive fluctuations in the foreign exchange market, if necessary, by direct intervention. Intervention in the form of selling the currency when it is overvalued and buying it when it tends to be undervalued.

4.1.4 Participants in the Foreign Exchange Market

The participants here refer to the people involved in the exchange or trade of foreign currency. These can be the buyers, sellers or the intermediaries.

The participants in a forex market include the following five parties:

1. **Central Bank**: The central bank regulates the exchange rates of the currency of their respective country to ensure fluctuations within the desired limit and keep control over the money supply in the market.

2. **Commercial Banks**: The commercial banks are the medium of forex transactions, facilitating international trade and exchange to its customers along with other forex functions like making foreign investments.

3. **Traditional Users**: The traditional users involve foreign tourists, companies carrying out business operations across the globe, patients taking treatment in other country's hospitals and students studying abroad.

4. **Traders and Speculators**: The traders and speculators are the opportunity seekers and look forward to making a profit through trading on short-term market trends.

5. **Brokers**: They are considered to be financial experts who act as an intermediary Traditional Users: The traditional users involve foreign tourists, companies carrying out business operations across the globe, patients taking treatment in other country's hospitals and students studying abroad.

4.2 Operation of The Foreign Exchange Market

The FX market is a global market *operating 24 hours a day*. It consists of a vast, highly sophisticated global network of telecommunication systems that provide current buy/sell rates for various currencies in dealing rooms located around the globe. It comprises all financial transactions denominated in foreign currency. FX is usually part of a banks treasury operation (dealing room).

Spot and Forward Transactions

FIGURE 15.1 TIMELINE OF TOD, TOM, SPOT AND FORWARD FX TRANSACTIONS

Value day	Today	Today + 1	Today + 2	Today + 3 and beyond
Transaction	Tod	Tom	Spot	Forward

The **Value Date** (delivery or maturity date) *refers to the FX contract date at which delivery of a currency & financial settlement occur*. **Spot transactions** have a maturity date 2 days after the contract is entered into, whilst **forward transactions** have value date in excess of 2 days. If it's the 13th Aug, the spot delivery date is the 15th & the 1 month forwards delivery date is Sept 15th.

Spot Market Quotations

Asking for A Quotations

The price of a currency must be expressed in terms of another currency. The **1st currency** is the '**base currency**' (unit of quotation or price being sought) & the **2nd** is the '**terms currency**'. *USD/AUD (USD – Base, AUD – Terms, this is the price of 1 USD in terms of AUD).*

2 Way Quotations

EUR/AUD 1.6755-65. The **lower number** is the dealers **buy (bid) price** & the **higher number** is the dealers **sell (offer) price**.

$$\%\,Spread = \frac{Offer\ Price - Bid\ Price}{Bid\ Price} \times 100 \rightarrow will\ only\ be\ a\ few\ points\ (the\ final\ decimal\ place\ in\ a\ FX\ quotation)$$

Transposing Quotations

EUR/AUD 1.6755-65

1. **Reverse** the bid & offer prices - EUR/AUD 1.6765-55
2. **Invert** - AUD/EURO 0.5965-68

Originally, the dealer would give (**sell**) 1.6755 AUD to buy 1 EURO. Thus 1.6755 AUD is the 'offer' for 1 EUR. Hence, if the dealer was to buy AUD (AUD/EUR) the offer is 0.5968 EUR for 1 AUD. Originally, the dealer would sell 1 EUR to get (**buy**) 1.6765 AUD. Thus 1.6765 AUD is what the dealer gets (**buys**) for 1 EURO. The dealer bids 1.6765 for 1 EURO which is AUD/EUR 0.5965.

To put it simply, the original bid refers to the rate at which the dealer would buy the base currency and sell the terms currency. Thus, the original bid is the offer rate when the original terms currency is transposed to become the base currency.

Calculating Cross Rates

All currencies are quoted against the USD. **Direct quotes** are when the **USD** is the **base currency** & **indirect quotes** are when the **USD** is the **terms currency**. *When FX transactions take place between 2 currencies, with neither being USD, a cross rate is calculated. E.g. can calculate EUR/JPY with EUR/USD & JPY/USD*

Crossing 2 Direct Foreign Exchange Quotations

Book Method

Crossing 2 Direct FX Quotations:

1. Place the currency that is to become the unit of quotation 1st
2. Divide opposite bid & offer rates
    1. Dividing the base currency offer into the terms currency bid = bid rate
    2. Divide base currency bid into terms currency offer = offer rate

Personal Method

Transpose one of the direct quotations (whilst aligning the correct base currency to what is required) to get a direct and an indirect quotation. Then you can simply multiply bid with bid and offer with offer. This can be seen in the below example.

$$E.g. USD/EUR\ .6450 - 55, USD/JPY\ 107.40 - 50\ than\ \frac{EUR}{JPY} = \frac{1}{\frac{USD}{EUR}}\ (transpose) \times \frac{USD}{JPY} = 166.38 - 67$$

Crossing A Direct and Indirect Quotations

Multiple bid with bid and offers with offer.

$$E.g. \frac{GBP}{USD} 1.9770 - 75, \frac{USD}{NZD} 1.3760 - 70\ than\ \frac{GBP}{NZD} = \frac{GPB}{USD} \times \frac{USD}{NZD} = 2.7204 - 30$$

Crossing 2 Indirect Foreign Exchange Quotations

Book Method

1. Place the currency that is to become the unit of quotation 1st
2. Divide opposite bid & offer rates
    1. Divide the terms currency offer rate into the base currency bid rate = bid rate
    2. Divide the terms currency bid rate into the base currency offer rate = offer rate

Personal Method

Transpose one of the indirect quotations (the exact one depends on the question - you must make sure the base currency is first). Then multiply bid with bid and offer with offer. This can be seen in the below example.

$$E.g. \frac{AUD}{USD} 0.9262 - 69, \frac{GBP}{USD} 1.9770 - 75 \text{ than } \frac{AUD}{GBP} = \frac{AUD}{USD} \times \frac{USD}{GBP} (transposed) = 0.4684 - 88$$

Forward Market Quotations

Foreign currencies may be bought/sold at a price determined today, but with delivery occurring at a specific date beyond spot.

Forward Points and Forward Exchange Rates

The **forward exchange rate** varies from the spot rate owing to **interest rate parity**. Interest rate parity is the *principle that exchange rates will adjust to reflect interest rate differentials between countries*. Forward exchange rates are quoted as forward points either above or below the spot rate. **Forward points represent the forward exchange rate variation to a spot rate base**.

- **If forward points are rising, add them to the spot rate**
  - *The base currency is at a forward premium as its interest rate is lower*
- **If forward points are falling, deduct them from the spot rate**
  - *The base currency is at a forward discount as its interest rate is higher*

This following 2 examples demonstrate the knowledge required for this course.

E.g. AUD/USD 0.9230-40 (spot), 0.0032-0.0027 6 month forward points, than the 6 month forward rate is 0.9198-9213 **Example 1**

$$Points = Spot \times \left(\frac{1+\left(\frac{I_t \times Forward\ Days}{Days\ in\ Year}\right)}{1+\left(\frac{I_b \times Forward\ Days}{Days\ in\ Year}\right)} - 1 \right)$$

E.g. USD/CHF 1.1560, 3month interest rate USD 3%, CHF 4%, than + 29 points as the base currency interest rate is lower. (360) **Example 2**

Forward Exchange Rate Contracts

Forward exchange rate contracts *lock in an exchange rate today for delivery at a specified future date*. FX dealers quote forward points on standard delivery dates, (usually monthly, out to 12 months) of a specified amount of currency against another. *In the previous example, the dealer buys 1 million USD (invests at 3% p.a. = 1,007,500) by borrowing CHF 1,156,000 (cost 4% p.a. = 1,167,560). The forward exchange rate is 1,167,560 / 1,007,500 = 1.1589 (29 points).*

Forward Market Complications

2 Way Quotations

FX quotes show what the buyer will pay for the base currency & the rate at which they will sell. Dealers must be careful in selecting appropriate bid/offer rates for forward points, cross rates, transposing etc.

Different Interest Rate Year Conventions
Dealers need to convert interest rates based on 360 days to 365 (or vice versa).

Borrowing and Lending Interest Rates
FX dealers need to recognise borrowing & lending interest rate margins.

$$Bid\ Forward\ Points = Spot_{bid} \times \left[\frac{1 + (It_{bid} \times Forward\ Days\ \div Days\ in\ Year)}{1 + (Ib_{offer} \times Forward\ Days\ \div Days\ in\ Year)} - 1\right]$$

$$Offer\ Forward\ Points = Spot_{offer} \times \left[\frac{1 + (It_{offer} \times Forward\ Days\ \div Days\ in\ Year)}{1 + (Ib_{bid} \times Forward\ Days\ \div Days\ in\ Year)} - 1\right]$$

E.g. USD/CHF 1.1555-60, 90 day forward contract, US Interest Bid/Offer 3%/3.3%, CHF Interest Bid/Offer 3.7%/4%

Bid Forward Points = 11 points, Offer Forward Points = 29 points

Compound Interest Rates
The effective value of deposits & cost of borrowings should be calculated by using the effective rate of interest.

4.3 Basics of Exchange Rate Determination
In a fixed exchange rate regime, exchange rates are decided by the government, while a number of theories have been proposed to explain (and predict) the fluctuations in exchange rates in a floating exchange rate regime, including:

- International parity conditions: Relative purchasing power parity, interest rate parity, Domestic Fisher effect, International Fisher effect. To some extent the above theories provide logical explanation for the fluctuations in exchange rates, yet these theories falter as they are based on challengeable assumptions (e.g., free flow of goods, services, and capital) which seldom hold true in the real world.
- Balance of payments model: This model, however, focuses largely on tradable goods and services, ignoring the increasing role of global capital flows. It failed to provide any explanation for the continuous appreciation of the US dollar during the 1980s and most of the 1990s, despite the soaring US current account deficit.
- Asset market model: views currencies as an important asset class for constructing investment portfolios. Asset prices are influenced mostly by people's willingness to hold the existing quantities of assets, which in turn depends on their expectations on the future worth of these assets. The asset market model of exchange rate determination states that "the exchange rate between two currencies represents the price that just balances the relative supplies of, and demand for, assets denominated in those currencies."

None of the models developed so far succeed to explain exchange rates and volatility in the longer time frames. For shorter time frames (less than a few days), algorithms can be devised to predict prices. It is understood from the above models that many macroeconomic factors affect the exchange rates and in the end currency prices are a result of dual forces of supply and demand. The world's currency markets can be viewed as a huge melting pot: in a large and ever-changing mix of current events, supply and demand factors are constantly shifting, and the price of one currency in relation to another shifts accordingly. No other market encompasses (and distills) as much of what is going on in the world at any given time as foreign exchange.
Supply and demand for any given currency, and thus its value, are not influenced by any single element, but rather by several. These elements generally fall into three categories: economic factors, political conditions and market psychology.

Economic factors
Economic factors include: (a) economic policy, disseminated by government agencies and central banks, (b) economic conditions, generally revealed through economic reports, and other economic indicators.

- Economic policy comprises government fiscal policy (budget/spending practices) and monetary policy (the means by which a government's central bank influences the supply and "cost" of money, which is reflected by the level of interest rates).
- Government budget deficits or surpluses: The market usually reacts negatively to widening government budget deficits, and positively to narrowing budget deficits. The impact is reflected in the value of a country's currency.
- Balance of trade levels and trends: The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. For example, trade deficits may have a negative impact on a nation's currency.
- Inflation levels and trends: Typically, a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power, thus demand, for that particular currency. However, a currency may sometimes strengthen when inflation rises because of expectations that the central bank will raise short-term interest rates to combat rising inflation.
- Economic growth and health: Reports such as GDP, employment levels, retail sales, capacity utilization and others, detail the levels of a country's economic growth and health. Generally, the healthier and more robust a country's economy, the better its currency will perform, and the more demand for it there will be.
- Productivity of an economy: Increasing productivity in an economy should positively influence the value of its currency. Its effects are more prominent if the increase is in the traded sector.

Political conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets.

All exchange rates are susceptible to political instability and anticipations about the new ruling party. Political upheaval and instability can have a negative impact on a nation's economy. For example, destabilization of coalition governments in Pakistan and Thailand can negatively affect the value of their currencies. Similarly, in a country experiencing financial difficulties, the rise of a political faction that is perceived to be fiscally responsible can have the opposite effect. Also, events in one country in a region may spur positive/negative interest in a neighbouring country and, in the process, affect its currency.

Market psychology

Market psychology and trader perceptions influence the foreign exchange market in a variety of ways:

- Flights to quality: Unsettling international events can lead to a "flight-to-quality", a type of capital flight whereby investors move their assets to a perceived "safe haven". There will be a greater demand, thus a higher price, for currencies perceived as stronger over their relatively weaker counterparts. The US dollar, Swiss franc and gold have been traditional safe havens during times of political or economic uncertainty.
- Long-term trends: Currency markets often move in visible long-term trends. Although currencies do not have an annual growing season like physical commodities, business cycles do make themselves felt. Cycle analysis looks at longer-term price trends that may rise from economic or political trends.

- "Buy the rumour, sell the fact": This market truism can apply to many currency situations. It is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and, when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being "oversold" or "overbought". To buy the rumour or sell the fact can also be an example of the cognitive bias known as anchoring, when investors focus too much on the relevance of outside events to currency prices.
- Economic numbers: While economic numbers can certainly reflect economic policy, some reports and numbers take on a talisman-like effect: the number itself becomes important to market psychology and may have an immediate impact on short-term market moves. "What to watch" can change over time. In recent years, for example, money supply, employment, trade balance figures and inflation numbers have all taken turns in the spotlight.
- Technical trading considerations: As in other markets, the accumulated price movements in a currency pair such as EUR/USD can form apparent patterns that traders may attempt to use. Many traders study price charts in order to identify such patterns.

4.4 Methods of Foreign Exchange Control

The various methods of exchange control may broadly be classified into two types, direct and indirect. Direct methods of exchange control include those devices which are adopted by governments to have an effective control over the exchange rate, while indirect methods are designed to regulate international movements of goods.

There are many ways to introduce exchange control in an economy. These are usually classified into two groups:

(i) Direct Exchange Control and

(ii) Indirect Exchange Control.

Direct Methods of Exchange Control:

In direct exchange control, certain measures are adopted which effectuate immediate direct restriction on foreign exchange from all sides – its quantum, use and allocation.

In general, direct exchange control includes measures like:

(i) Intervention;

(ii) Exchange restrictions;

(iii) Exchange clearing agreements;

(iv) Payment agreements; and

(v) Gold policy.

Indirect Methods of Exchange Control:

Apart from the direct methods, there are several indirect methods also regulating the rates of exchange. Important ones are briefly discussed below.

(i) Changes in Interest Rates

(ii) Tariffs Duties and Import Quotas

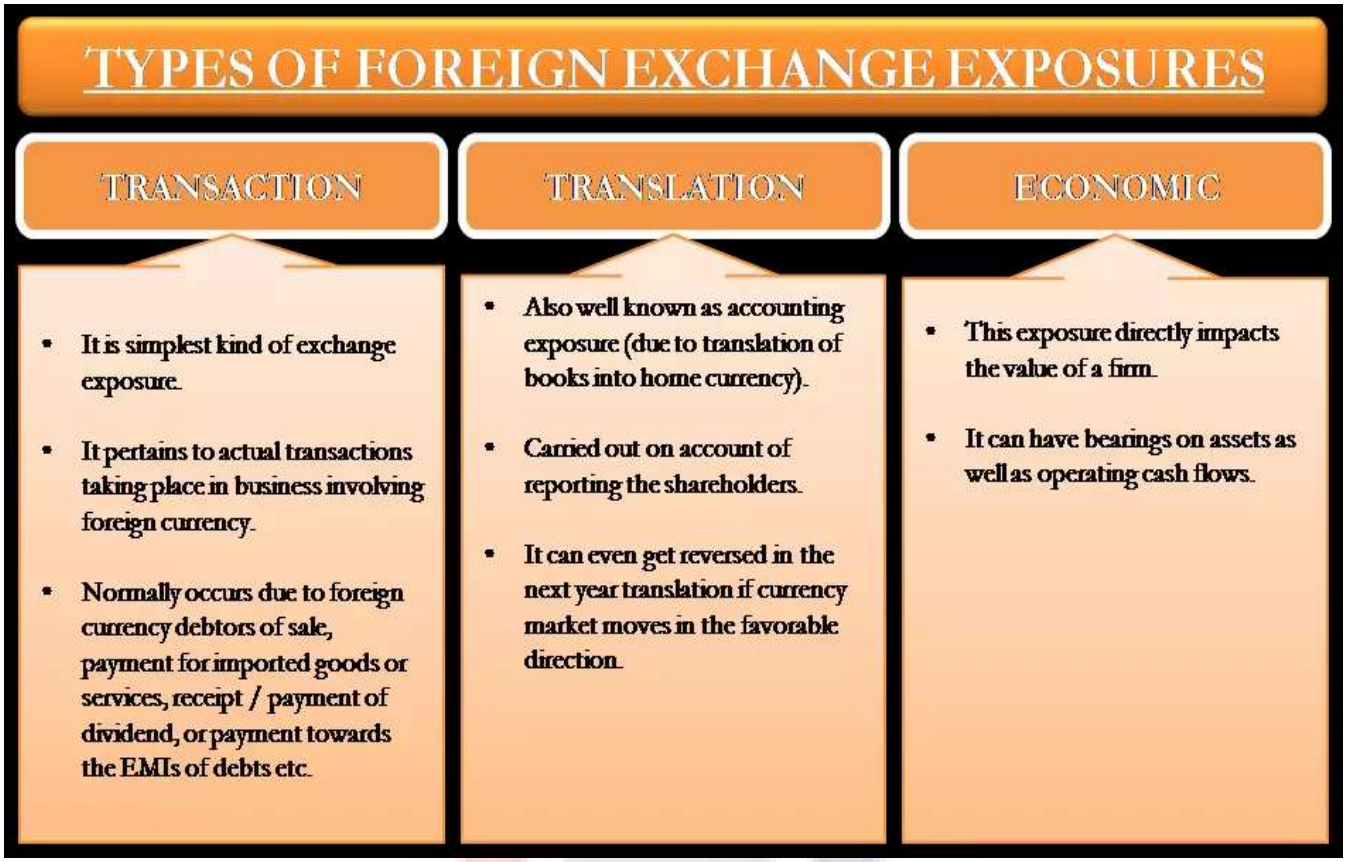
(iii) Export Bounties

4.5 Exchange Risk Management

Foreign Exchange Risk

Foreign exchange risk refers to the losses that an international financial transaction may incur due to currency fluctuations. Also known as currency risk, FX risk and exchange-rate risk, it describes the possibility that an investment's value may decrease due to changes in the relative value of the involved currencies. Investors may experience jurisdiction risk in the form of foreign exchange risk.

Types of Exposure:



4.6 Role of RBI in controlling Foreign Exchange Market

Foreign Exchange Management Act ("FEMA") envisages that Reserve Bank of India ("RBI") will have a key role in management of foreign exchange. The main functions of RBI under FEMA are as follows:

a) Controlling dealings in foreign exchange by giving general or special permission for dealing in foreign exchange, excluding those cases where specific provisions have been made in Act, Rules or Regulations – Section 3.

b) RBI cannot impose any restrictions on current account transactions. These can be imposed only by Central Government in consultation with RBI – Section 5. However, in certain cases, prior approval of RBI is required for current account transactions as provided in Foreign Exchange Management (Current Account Transactions) Rules, 2000.

c) Specifying conditions for payment in respect of capital account transaction – Section 6(2).

d) Regulate/prohibit/restrict the following, by issuing Regulations:
• Transfer or issue of foreign security to resident and Indian security to non-resident;
• Borrowing and lending in foreign exchange or to a foreign person;
• Export/import of currency or currency notes;
• Transfer of immovable property outside India;
• Giving guarantee or surety where foreign exchange transaction is involved – Section 6(3)

e) Specify (by regulation) period and manner in which foreign exchange due from export of goods and services should be received – Section 8.

f) To grant exemption from realisation and repatriation in cases specified under Section 9.

g) Granting authorisation to 'Authorised Person' to deal in foreign exchange, to give directions to them and to inspect the authorised person – Sections 10, 11 & 12.

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