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The role of financial markets in economic growth: An Indian perspective

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Abstract
Financial markets that function well are crucial for the long-run economic growth of a country. This paper, provides an insight to Financial Markets, functioning of Financial markets and how the financial markets play a role in development of an. It highlights the dualistic development of the financial sector. This paper makes an attempt to offer an explanation of the development and proposes a road map for the future development of financial markets in India.

Keywords: financial markets, economic growth, development

Introduction

It is well recognized in economic literature that efficient and developed financial markets can lead to increased economic growth by improving the efficiency of allocation and utilization of savings in the economy. Better functioning financial systems ease the external financing constraints that impede firm and industrial expansion. There is a growing body of empirical analyses, including firm-level studies, industry-level studies, individual country studies, and cross-country comparisons, that prove this strong, positive link between the functioning of the financial system and long-run economic growth. Specifically, financial systems facilitate the trading, hedging, diversifying, and pooling of risk. In addition, they better allocate resources, monitor managers and exert corporate control, mobilize savings, and facilitate the exchange of goods and services. India is one of the five countries classified as big emerging market economies by the World Bank. This list also includes People's Republic of China (PRC), Indonesia, Brazil, and Russia. These countries have made the critical transition from a developing country to an emerging market. The World Bank has predicted that these five biggest emerging markets' share of world output will have more than doubled from 7.8% in 1992 to 16.1% by 2020. Thus well-functioning financial markets are critical, especially for emerging market economies (EMEs). Using mainly the World Economic Forum (WEF) financial development indicators, one can see where emerging market economies (EMEs) stand in terms of domestic financial development vis-à-vis the developed economies and where India stands among the EMEs in the area of financial development. India is contributing significantly to the increase in trade and economic activity, and thus to world economic growth. Hence it is important to look at the manner in which financial development has occurred in India and how it has been instrumental in shaping the contours of India's economic progress and in turn shaped by it. It will also be instructive to study what more India must do to join the league of countries known for their efficient financial sectors and markets.

The role of financial markets in resource mobilization

At any point in time, we have people that have money that they don't want to spend but rather save for future uses. This set of people choose to save because they have more than what they needed to spend for the time being. On the other hand, there are people that want to spend money to undertake some economic activities but don't have the required amount of financial resources. Though some do have some money, it may not be enough to fully finance the intended activity. For instance, an individual may want to start a small private business but lacks enough money to finance the business. In that case he/she may need additional financial resources to fully finance his/her business. The Government for instance would like to construct of a well equipped modern Hospital or construct a well paved high way linking Sierra Leone to neighbouring countries like Guinea and Liberia but may not have enough economic resources to finance the projects. As a result, the Government may want to quickly access additional financial resources through borrowing from the general public. In another example, a university student may want to pay his/her college fees but may not have adequate funds to do so and may look for an opportunity to borrow. A company may also want to build a new factory to increase its production owing to the increasing demand for its products but may not have additional funds to finance the building of the factory. Thus the management of the company may want to access additional funds by taking a loan from somewhere. In all these cases, it will be practically difficult to easily identify someone or a set of people that can easily afford to lend the 4 Government, the student, the businessman and the company the amount of money they respectively needed to execute their intended expenditures. As a result, most economies around the world therefore rely principally upon the market system to carry out the complex task of allocating scarce resources. By definition, a market is a place or a mechanism through which buyers and sellers exchange goods and services using a generally accepted medium of Exchange (i.e. Money). Thus, just like any other market, the Financial Market is a specialized market that is responsible for channeling financial

resources from the surplus units (savers) to the deficit units (those who needed additional funds) to carry out some form of economic activities. The Financial Market therefore constitute of all financial institutions that receive financial resources from the surplus units of the economy in the form of savings and transfer them to the deficits units through lending activities. This role of transferring financial resources from the surplus units to the deficit units is what is referred to as financial intermediation. Thus, a Financial Market comprises of all institutions that play the role of financial intermediation. These set of institutions are therefore referred to as financial intermediaries. The businessman who needed some additional money to start his business, the Government that needed more funds to undertake developmental projects, the student that needed a loan to pay his/her college fees, and the company that needed more finances to expand its operation will all find the financial Market a useful avenue to access additional funding.

Division of the financial market

The Financial market is divided into two main divisions, namely (i) the Money Market, and (ii) the Capital Market. The Money Market is quite different from the Capital Market in the sense that, unlike the Capital Market, one cannot raise long-term capital from the Money Market. The existence of money markets facilitate trading in short-term debt instruments to meet short-term needs of large users of funds such as governments, banks and similar institutions. Government treasury bills and similar securities, as well as company commercial bills, are examples of instruments traded in the money market. A wide range of financial institutions, including merchant banks, commercial banks, the central bank and other dealers operate in the money market. Public as well as private sector operators make use of various financial instruments to raise and invest short-term funds which, if need be, can be quickly liquidated to satisfy short-term needs.

Unlike the Money market, the Capital market is that constituent of the Financial Market that facilitates the mobilization of long-term investment capital for the financing of business enterprises as well as Government long term investment projects. In other words, the term Capital Market refers to a specialized financial institution that provides a channel for the borrowing and lending of long-term funds (i.e. over one year). It is a well organized financial institution that facilitates the transfer of financial resources from those that have surplus funds (savers) to those that needed the use of these funds (i.e. Government and private sector businesses) to undertake long-term investment. Thus the Capital Market offers an opportunity for both private business people and Government to mobilize huge amounts of financial resources from the general public through the sale of financial securities. The Capital Market is divided into two areas; the Primary Market and the Secondary Market. The Primary Market deals with the trading of new securities. When a company issues securities for the first time (i.e. IPO), they are traded in the Primary Market through the help of issuing houses, Dealing /Brokerage Firms, Investment Bankers and or Underwriters. The acronym IPO stands for Initial Public Offering, which means the first time a company is offering securities to the general public for subscription. The amount of money raised in the Primary market goes directly to the Issuing Company/Firm to finance its operations. Once the securities (shares) of a company are in the hands the general public, they can be traded in the Secondary Market to enhance liquidity amongst holders of such financial securities. Thus, the Secondary Market facilitates the buying and selling of securities that are already in the hands of the general public (investors). Here, the term investor is used to refer to an individual or an institution that buys the securities (Shares) of a Company with the intent of making some financial returns.

The Stock Exchange therefore is an organized financial platform that deals in transactions involving the buying and selling of financial securities in the Secondary Market. In short, the Stock Exchange does the work of a Secondary Market by facilitating a formal trading arrangement for financial securities.

The key players in the capital market

The key actors in a well organized Stock Exchange include the Dealers/Stock Brokers, Registrars, Issuing Houses, Mutual Fund Managers, Stock Exchanges in India, Regional Stock Exchanges, Depository system of India, National Securities Depository LTD. (NSDL), Central Depository Services LTD (CDSL), Investing Public, Accountants (Auditors) and Solicitors

a. **Stock Brokers:** A stockbroker is a licensed member of a Stock Exchange that buys and sells financial securities for their clients/customers. That is, a Stockbroker is an agent that simply buys or sells securities on the behalf of an investor. This simply means that a Stockbroker executes trade on the instruction of his/her customer. Because he/she is trading on the behalf of someone (the investor), he/she gets his/her compensation by levying some form of tax (i.e. a commission) from the proceeds of the trade. On the other hand, a dealer buys and sells financial securities on his/her own account. In other words, a dealer enters the market as a buyer or seller of securities using his/her own financial resources. Thus, his/her compensation depends on the outcome of the trade. If he/she can buy at a lower price and sells at a higher price, then he/she will make a capital gain. If the reverse holds, then he/she is liable to make a capital loss which he/she has to bear up alone. In some cases, an individual/institution can act in the capacity of a Stockbroker as well as a dealer in securities. In this case, the institution or individual is referred to as a Dealer-Broker. In a Dealer-Broker setting, the individual can buy or sell securities for him/her self or for some other person with the hope of making a commission.
b. **Registrars:** Registrars are a group of operators in the capital market that are charged with the responsibility of keeping records on the ownership of a company's securities. They ensure that details on the transfer of ownership of securities from one investor to another are well recorded to avoid confusion on claims arising from benefits associated with holding such securities. During the allotment stage of an oversubscribed issue of securities, Registrars prepare a range of analysis on how the securities should be allotted. They also prepare the list of investors that qualify to receive dividend from the Company's annual dividend disbursement to shareholders.

c. **Issuing Houses:** An Issuing House is normally a licensed corporate body that acts as an agent for an issuer of securities in the primary market. Marketing of the securities issued by an issuer is very crucial in the Capital market. Issuing Houses perform this function by helping the issuer in packaging and marketing the offer of securities to the general public. They can normally underwrite the offer of securities by providing the issuer with the required financial resources and eventually sell the securities to the general public. That is, instead of the issuer having to wait until the securities are sold, an Issuing House can buy the securities at a discount thereby making the needed funds immediately available to the issuer. Sometimes, instead of underwriting the offer, an Issuing House can simply use its best effort in selling the securities to the general public. In this situation, an Issuing House will not undertake any responsible for securities that are not bought.
d. **Mutual fund managers:** Mutual Funds or Unit Trust Funds are non-bank financial institutions that mobilize financial resources from the general public for investment in the capital market. As a result of his/her expertise in portfolio management, a Mutual Fund Manager reduces the risk of investors by diversifying investment from the pool of funds into various securities. Thus by pooling resources from many individual investors and investing in various securities in the capital market, a Mutual Fund Manager reduces idiosyncratic risk through portfolio diversification.
e. **Stock exchanges in India:** The stock exchanges are the important player of the capital market. They are the citadel of capital and fortress of finance. They are the platform of trading in securities and as such they assists and control the buying and selling of securities. Thus, stocks exchanges constitute of a market where securities issued by the central and state, governments, public bodies and joint stock companies are traded. There are mainly four stock exchanges in India as follow:
   1. Bombay Stock Exchange (BSE)
   2. National Stock Exchange (NSE)
   3. The Over The Counter Exchange of India (OTCEI)
   4. Regional Stock Exchanges
f. **Regional Stock Exchanges:** The regional stock exchanges provided investors an access to big brokers in Mumbai. They also served as a link between the local companies and local investors. They promoted trading in local scripts. This lead to a competition among issuer and they listed their securities on as many exchanges as possible to attract investors from all over the country. Each regional stock exchange followed its own practice and procedures in respect of listing and trading of securities, clearing and settlement of transaction, and risk containment measures. The main Regional Stock Exchanges in India are: 1. Bombay Stock Exchange 2. National Stock Exchange 3. Over The Counter Stock Exchange 4. Kolkata Stock Exchange 5. Uttar Pradesh Stock Exchange 6. Ahmedabad Stock Exchange 7. Delhi Stock Exchange 8. Pune Stock Exchange 9. Ludhiana Stock Exchange 10. Bangalore Stock Exchange 11. Hyderabad Stock Exchange 12. Saurashtra and Kachchh Stock Exchange 13. Chennai Stock Exchange 14. Madhyaprades Stock Exchange 15. Vadodara Stock Exchange 16. Guwahati Stock Exchange 17. Bhuvaneshwar Stock Exchange 18. Coachin Stock Exchange 19. Magadh Stock Exchange 20. Coimbatore Stock Exchange 21. Jaipur Stock Exchange 22. Manglore Stock Exchange
g. **Depository system of India:** A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act, 1996. In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the provisions of the SEBI Act. As per the provisions of this Act, a DP can offer depository related services only after obtaining a certificate of registration from SEBI.
h. **National Securities Depository LTD. (NSDL):** The NSDL, the first depository in India which has been promoted by three premier institutions in India, i.e. Industrial Development Bank of India, UTI and NSE. The NSDL started from November 8 1996. The NSDL is a public limited company framed under the companies Act 1956 wit a paid up capital of Rs. 105 crore, The NSDL carries out its operations through participants and the clearing corporation of the stock exchange, wit participants acting as market intermediaries through whom NSDL interacts with the investors and clearing members.
i. **Central Depository Services LTD (CDSL):** CDSL was promoted by Bombay Stock Exchange Limited (BSE) jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank, Union Bank of India and Centurion Bank. CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. It commenced its operation n march 22 1999. BSE has 45% stake in CDSL while the bank have a 55% stake. CDSL has been preferred platform by the government of India for carrying out actual share transactions PSUs disinvestment have been done through CDSL system. Every transaction at CDSL is doing at one e-space. The centralized system of CDSL keeps a watch on every transaction. All leading stock exchanges have established connectivity with the CDSL.
j. **Investing Public:** An investor is an individual or an institution that buys financial securities with the sole purpose of making some financial returns from the investment. Investors cannot buy securities directly from the Stock Exchange except through a licensed stock broker. When an investor is desirous of buying securities from the Capital Market, he/she approaches a Stock Broker who will execute his/her mandate in the market.
k. **Accountants (Auditors) and Solicitors:** Accountants and Solicitors are also very important players in the Capital Market. The full disclosure requirements for listed Companies in the Capital market necessitated the regular publication of financial statements of listed companies. Prior to the publication of such financial statements, certified accountants (Auditors) are required to

authenticate the extent to which such financial statements can reliably inform the true picture of the Company's financial position. This is meant to provide an accurate guide for investors' decision making. Listed Companies also needed the services of Solicitors to interpret the legal implications of some of the rules and regulations guiding their participation in the capital market. These rules and regulations may either be those of the Securities and Exchange Commission (SEC) or those of the Sock Exchange. In either case, a legally minded person is required by Listed Companies for the interpretation of the laws regulating their activities in the capital market.

The role of financial markets in economic growth

Financial Markets play an important role in promoting economic growth. It is commonly argued in the economic literature that a well functioning financial sector creates strong incentives for investment and also fosters trade and business linkages thereby facilitating improved resource use and technological diffusion. By mobilizing savings for productive investment and facilitating capital inflows, financial markets stimulates investment in both physical and human resources. The financial sector also channels savings to more productive uses by collecting and analyzing information about investment opportunities. It has also been argued that the financial system can enhance efficiency in the corporate sector by monitoring management and exerting corporate controls. Public as well as private sector operators make use of various financial instruments to raise and invest short term funds which, if need be, can be quickly liquidated to satisfy short-term needs. The Central Government, for instance, can borrow money from the general public to finance long-term investment projects by issuing treasury notes or bonds. The proceeds from the bonds issue can be used to build public hospitals, construct roads, provide public transports, build airports, construct dams, or build other social infrastructures. This entails national wealth creation for economic growth. The Government of Sierra Leone can mobilize a huge amount of financial resources from the Capital Market to finance long term development projects. In many countries, local government authorities issue municipal bonds to finance long-term projects like the construction of public markets, recreational centers, roads, develop efficient transport system, build Schools, hospitals and provide many other services from which they can generate a regular source of income. The Freetown City Council as well as those in the provinces can issue municipal bonds to develop social infrastructures. Corporate bonds can be issued by public companies to finance long-term development projects like the construction of new plants, expansion of existing plants, construction of new buildings, introduction of new technology, purchase of new equipments etc. Corporations can also issue equities (Common Stocks and preferred stocks) to raise additional financial resources for long term investment. The proceeds from equities could be Use to purchase new equipment, construct new factories, expand operations etc. All these activities; the purchase of new equipments, expansion of existing plants, construction of new buildings etc, entail wealth creation from the Capital Market by corporations. Investors make money in the Capital Market through buying and selling of financial securities. When investors buy debt instruments like government bonds, municipal bonds or corporate bonds, they receive an interest payment from the issuer of the debt security plus the principal amount at the end of the loan period. The amount of interest payable to an investor holding a debt security depends on the interest rate agreed by the loan contract. The higher the interest rate on a debt security, the higher the expected interest payment.

Role of capital market

Capital market plays an extremely important role in promoting and sustaining the growth of an economy. It is an important and efficient conduit to channel and mobilize funds to enterprises, and provide an effective source of investment in the economy. It plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country's long-term growth prospects. It thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena.

Capital markets play a vital role in Indian economy, the growth of capital markets will be helpful in raising the per-capita income of the individuals, decrease the levels of un-employment, and thus reducing the number of people who lie below the poverty line. With the increasing awareness in the people they start investing in capital markets with long-term orientations, which would provide capital inflows to the sectors requiring financial assistance.

1. **Capital Arrangement:** The capital market promotes capital formation in the country. Rate of capital formation depends upon savings in the country. Though the banks mobilize savings, they are not adequate to match the requirements of the industrial sector. The capital market mobilizes savings of households and of the industrial concern. Such savings are then invested for productive purposes. Thus savings and investment leads to capital arrangement in country.
2. **Economic Growth:** Capital market smooths the progress of the growth of the industrial sector as well as other sectors of the economy. The main purpose of the capital market is to transfer resources from masses to the industrial sector. The capital market makes it possible to lend funds to various projects, both in the private as well as public sector.
3. **Development of backward areas:** The capital markets provide funds for the projects in backward areas. This facilitates the economic development of backward areas.
4. **Generates Employment:** Capital market generates employment in the country:
    a. Direct employment in the capital markets such as stock markets, financial institutions etc.
    b. Indirect employment in all sectors of the economy, because of the funds provided for developmental projects.
5. **Long term capital to industrial sector:** The capital market provides a stable long-term capital for the companies. Once, the funds are collected through issues,

the money remains with the company. The company is left free with the funds while investors exchange securities among themselves.

6. **Generation of foreign capital:** The capital market makes possible to generate foreign capital. Indian firms are able to generate capital from overseas markets by way of bonds and other securities. Such foreign exchange funds are vital for the economic development of the nation.
7. **Developing role of financial institutions:** The various agencies of capital market such as industrial financial corporation of India (IFCI), state finance corporations (SFC), industrial development bank of India (IDBI), industrial credit and investment corporation of India (ICICI), unit trust of India (UTI), life insurance corporation of India (LIC), etc. there have been rendering useful services to the growth of industries. They have been financing, promoting and underwriting the functions of the capital market.
8. **Investment opportunities:** Capital markets provide excellent investment opportunities to the members of the public. The public can have alternative source of investment i.e. In bonds, shares and debentures etc.

Conclusion

The Financial Market plays an important role in promoting economic growth. By mobilizing savings for productive investment and facilitating capital inflows, it stimulates investment in both physical and human capital. The Financial Market also channels savings to more productive uses by collecting and analyzing information about investment opportunities. Thus, by creating an efficient mechanism for transactions in long term financial instruments, it provides a wide range of wealth creating opportunities for the Government, Corporations, Private individuals, and other financial institutions.

I close this paper with the following excerpt from the Committee on Financial Sector Assessment (Government of India and Reserve Bank of India, 2009, Chapter 4, page 296): ―Stability in financial market augurs well for financial soundness. In fact, markets are the major conduits for transmission of impulses which could either enhance or impact the stability of the financial system as a whole. While financial market reforms need to be accorded appropriate priority, given the risks arising from cross-sectoral spillover of financial markets to other segments of financial spectrum, there is a need to be careful and nuanced in approaching financial markets reforms in the interest of financial stability

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