UNIT 4

Economic Growth and Development

Chapter 1

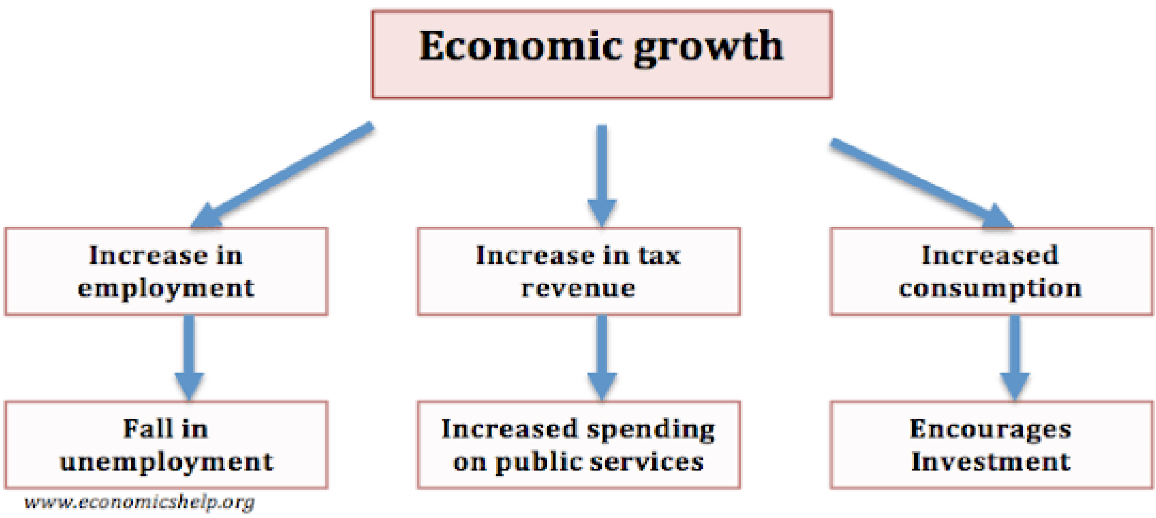
Economics Growth

The term economic growth is defined as the process whereby the country's real national and per capita income increases over a long period of time.

This definition of economic growth consists of the following features of economic growth:

- **Economic Growth implies a process of increase in National Income and Per-Capita Income.** The increase in Per-Capita income is the better measure of Economic Growth since it reflects increase in the improvement of living standards of masses.
- **Economic Growth is measured by increase in real National Income and not just the increase in money income or the nominal national income.** In other words the increase should be in terms of increase of output of goods and services, and not due to a mere increase in the market prices of existing goods.
- **Increase in Real Income should be Over a Long Period**: The increase of real national income and per-capita income should be sustained over a long period of time. The short-run seasonal or temporary increases in income should not be confused with economic growth.
- **Increase in income should be based on Increase in Productive Capacity:** Increase in Income can be sustained only when this increase results from some durable increase in productive capacity of the economy like modernization or use of new technology in production, strengthening of infrastructure like transport network, improved electricity generation etc.

➢ Long Term Significance / Importance of Economic Growth



Economic growth can help various macroeconomic objectives

1. Reduction in poverty. Increased national output means households can enjoy more goods and services. For countries with significant levels of poverty, economic growth can enable vastly improved living standards. For example, in the nineteenth century, absolute poverty was widespread in Europe, a century of economic growth has lifted nearly everyone out of this state of poverty. Economic growth is particularly important in developing economies.

2. Reduced Unemployment. A stagnant economy leads to higher rates of unemployment and the consequent social misery. Economic growth leads to higher demand and firms are likely to increase employment.

3. Improved public services. Higher economic growth leads to higher tax revenues (even with tax rates staying the same). With higher growth, incomes and profit, the government will receive more income tax, corporation tax and expenditure taxes. The government can then spend more on public services.

4. Reduced debt to GDP ratios. Economic growth helps reduce debt to GDP ratios. In the 1950s, the UK had a national debt of over 200% of GDP. Despite very few years of budget surplus, economic growth enabled a reduction in the level of debt to GDP.

5. Political aspect. Elected politicians have a vested interest in higher economic growth. Higher growth enables vote pleasing policies such as tax cuts and/or more public spending.

6. Higher living standards – i.e. Real GNI per capita – helps to lift people out of extreme poverty and improve development outcomes (e.g. rising HDI)

7. Better Facilities & infrastructure: Continuing rapid economic growth enables advanced industrial countries to provide more of everything to their citizens—better food and bigger homes, more resources for medical care and pollution control, universal education for children, better equipment for the military, and public pensions for retirees.

➢ The Four Wheels of Growth

Economists who have studied growth have found that the engine of economic progress must ride on the same four wheels, no matter how rich or poor the country. These four wheels, or factors of growth, are:

- Human resources (labor supply, education, skills, discipline, motivation)
- Natural resources (land, minerals, fuels, environmental quality)
- Capital (factories, machinery, roads, intellectual property)
- Technological change and innovation (science, engineering, management, entrepreneurship)

Economists write the relationship in terms of an aggregate production function (or APF), which relates total national output to inputs and technology. Algebraically, the

$$\text{APF is } Q = AF(K, L, R)$$

where Q = output, K = productive services of capital, L = labor inputs, R = natural-resource inputs, A represents the level of technology in the economy, and F is the production function.

As the inputs of capital, labor, or resources rise, we would expect that output would increase, although output will probably show diminishing returns to additional inputs of production factors. We can think of the role of technology as augmenting the productivity of inputs. Productivity denotes the ratio of output to a weighted average of inputs.

As technology (A) improves through new inventions or the adoption of technologies from abroad, this advance allows a country to produce more output with the same level of inputs.

Human Resources

Labor inputs consist of quantities of workers and of the skills of the workforce. Many economists believe that the quality of labor inputs—the skills, knowledge, and discipline of the labor force—is the single most important element in economic growth. A country might buy fast computers, modern telecommunications devices, sophisticated electricity-generating equipment, and hypersonic fighter aircraft. However, these capital goods can be effectively used and maintained only by skilled and trained workers. Improvements in literacy, health, and discipline, and most recently the ability to use computers, add greatly to the productivity of labor.

Natural Resources

The second classic factor of production is natural resources. The important resources here are arable land, oil, gas, forests, water, and mineral deposits. Some high-income countries like Canada and Norway have grown primarily on the basis of their ample resource base, with large output in oil, gas, agriculture, fisheries, and forestry. Similarly, the United States, with its fertile farmlands, is the world's largest producer and exporter of grains.

But the possession of natural resources is not necessary for economic success in the modern world. New York City prospers primarily on its high-density service industries. Many countries, such as Japan, had virtually no natural resources but thrived by concentrating on sectors that depend more on labor and capital than on indigenous resources. Indeed, tiny Hong Kong, with but a tiny fraction of the land and natural resources of Nigeria, actually has a larger GDP than does that giant country.

Capital

Capital includes tangible capital goods like roads, power plants, and equipment like trucks and computers, as well as intangible items such as patents, trademarks, and computer software. The most dramatic stories in economic history often involve the accumulation of capital. In the nineteenth century, the transcontinental railroads of North America brought commerce to the American heartland, which had been living in isolation. In the twentieth century, waves of investment in automobiles, roads, and power plants increased productivity and provided the infrastructure which created entire new industries. Many

When we think of capital, we must not concentrate only on computers and factories. Many investments that are necessary for the efficient functioning of the private sector will be undertaken only by governments. These investments are called **social overhead capital** and consist of the large-scale projects that precede trade and commerce. Roads, irrigation and water projects, and public-health measures are important examples. All these involve large investments that tend to be "indivisible," or lumpy, and sometimes have increasing returns to scale. These projects generally involve external economies, or spillovers that private firms cannot capture, so the government must step in to ensure that these social overhead or infrastructure investments are effectively undertaken. Some investments, such as transportation and communication systems, involve "network" externalities in which productivity depends upon the fraction of the population which uses or has access to the network.

Technological Progress: Technological progress is a very important factor in determining the rate of economic growth. Technological progress mainly implies the research into the use of new and better methods of production or the improvement of the old methods. Sometimes technical progress results in the availability of natural resources. But generally technological progress results in increase in productivity. In other words, technological progress increases the ability to make a more effective and fruitful use of natural and other resources for increasing production. By the use of improved technology it is possible to have greater output from the use of given resources or a given output can be obtained by the use of a smaller quantity of resources. The technological progress improves an ability to make a fuller use of the natural resources e.g. with the aid of power - driven farm equipment a marked increase has been brought about in agricultural production. The USA, UK, France, Japan and other advanced industrial nations have all acquired the industrial strength from use of advanced technology. In fact economic development is facilitated with the adoption of new techniques of production.

Chapter 2

Economics Development

➢ Meaning:

Economic development is defined as a sustained improvement in material wellbeing of society. Economic development is a wider concept than economic growth. Apart from growth of national income, it includes changes – social, cultural, political as well as economic which contribute to material progress.

It contains changes in resource supplies, in the rate of capital formation, in size and composition of population, in technology, skills and efficiency, in institutional and organizational set-up. These changes fulfill the wider objectives of ensuring more equitable income distribution, greater employment and poverty alleviation.

In short, economic development is a process consisting of a long chain of interrelated changes in fundamental factors of supply and in the structure of demand, leading to a rise in the net national product of a country in the long run.

The economic growth is a narrow term. It involves increase in output in quantitative terms but economic development includes changes in qualitative terms such as social attitudes and customs along with quantitative growth of output or national income. Economic development without growth is almost inconceivable.

The comparison between the two concepts is given in the following table:

	Economic Growth	Economic Development
Meaning	Economic growth refers to an increase in the real output of goods and services in the country.	Economic development implies changes in income, savings and investment along with progressive changes in socio-economic structure of country (institutional and technological changes).
Factors:	Growth relates to a gradual increase in one of the components of Gross Domestic Product: consumption, government spending, investment, net exports.	Development relates to growth of human capital, decrease in inequality figures, and structural changes that improve the quality of life of the population.
Measurement:	Economic Growth is measured by quantitative factors such as increase in real GDP or per capita income	The qualitative measures such as HDI (Human Development Index), gender- related index, Human poverty index (HPI), infant mortality, literacy rate etc. are used to measure economic development.
Effect:	Economic growth brings quantitative changes in the economy.	Economic Development leads to qualitative as well as quantitative changes in the economy.
Relevance:	Economic growth reflects the growth of national or per capita income.	Economic development reflects progress in the quality of life in a country.

➢ Criteria/ Measures of Economic Development

Generally, economic development is a process of change over a long period of time. Though there are several criteria or principles to measure the economic development, yet none provides a satisfactory and universally acceptable index of economic development. Hence, it is a complex problem to answer about the measuring of economic development.

Most commonly used criteria of economic development are increase in national income, per capita real income, comparative concept, standard of living and economic welfare of the community etc.

1. National Income as an Index of Development:

There is a group of certain economists which maintains the growth of national income should be considered most suitable index of economic development. They are Simon Kuznets, Meier and Baldwin, Hicks D. Samuelson, Pigon and Kuznets who favored this method as a basis for measuring economic development. For this purpose, net national product (NNP) is preferred to gross national product (GNP) as it gives a better idea about the progress of a nation. "Total income is a more appropriate concept to measure welfare than income per capita." Therefore, in measurable economic development, the most appropriate measure will be to include final goods and services produced but we must allow for the wastage of machinery and other capital goods during the process of production.

- ✓ **Arguments in Favour of National Income:**

There are certain arguments for stressing real national income as a measurement of economic development They are:

(i) A larger real national income is normally a pre-requisite for an increase in real per capita income and hence, a rising national income can be taken as a token of economic development.

(ii) If per capita income is used for measuring economic development, the population problem may be concealed, since population has already been divided out. In this context, Prof. Simon Kuznets writes, "The choice of per capita, per unit or any similar measure to gauge the rate of economic growth carried with it danger of neglecting the denominator of the ratio."

(iii) If an increase in per capita income is taken as the measure of economic development, we are likely to be put in an awkward situation of saying that a country has not developed if its real national income has increased but its population has also increased at the same rate.

- ✓ **Arguments against National Income:**

Despite the favourable arguments, national income as a measure of economic development suffers from certain shortcomings:

(i) It cannot definitely be said that economic welfare has increased if the national and even the per capita income may be rising unless the distribution of income is equitable.

(ii) Expansion of national and per capita income cannot be identified with enrichment because the composition of the total output is also important. For example, an expansion of total output could be accompanied by a depletion of natural resources or it could compose of only armaments or could consist of merely a greater output of capital goods.

(iii) It must not only consider what is produced but also how it is produced. It is possible that when real national output grows, the real costs i.e., 'pain and sacrifice' of the society may also grow.
(iv)It is difficult to determine proper deflators to eliminate the effects of price changes in an underdeveloped country.
(v) It is also complicated when average income is rising but unemployment exists due to the rapid growth of population, thus, such a situation is not consistent with the development.

2. Per Capita Real Income:

Some economists believe that economic growth is meaningless if it does not improve the standard of living of the common masses. Thus, they say that the meaning of economic development is to increase aggregate output. Such a view holds that economic development be defined as a process by which the real per capita income increases over a long period time. Harvey Leibenstein, Rostow, Baran, Buchanan and many others favour the use of per capita output as an index of economic development.

- ✓ **Arguments in favour of per Capita Real Income:**

i) The aim of economic development is to raise the living standard of the people and through this to raise consumption level. This can be, estimated through per capita income rather than national income. If national income of a country goes up but the per capita income is not increasing, that will not raise the living standard of the people. That way, per capita income is a better measure of economic development than the national income.

ii)The increase in per capita income is a good measure of economic development. In the advanced countries, per capita income has been on continuous increases because the growth rate of national income is greater than the growth rate of population. This has raised the economic lot of the people. In underdeveloped countries, there is very less capacity to produce per head. So, as the capacity to produce goes up these economies proceed towards economic development.

iii) Increase in per capita income can be better index of an increase in the welfare of the people. In advanced countries, national income has increased much faster than the growth rate of population. It means the per capita real income has been constantly increasing and this has led to the increase in welfare of the people. That way, per capita income can be considered a better index of the welfare of the people.

- ✓ **Arguments against Per Capita Real Income:**

The real per capita income, a measure of economic development has been severely criticized by Jacob Viner, Kuznet etc.

(a) According to Meier and Baldwin, "If an increase in per capita income were taken as the measure of development, we would be in the awkward position of having to say that a country had not developed if its real national income had risen, but population has also risen at the same time." If in a country an increase in national income is offset by the increase in population, then we would be bound to say that no economic development has taken place. Similarly, if national income in a country has not gone up but population has reduced due to epidemic or war, in that case we would be bound to conclude that economic development is taking place.

(b) When we divide national income by population, the problem of population in that case is ignored. It confines the scope of the study.

(c) In this measure, distributive aspect has been ignored. If national income goes up but there is unequal distribution of income among different sections of the society, in that case rise in national income will be meaningless.

(d) In the underdeveloped countries where per capita income is regarded as a measure of economic development, with the increase in per capita income of these countries, there is also increase in unemployment, poverty and income inequalities. This cannot be regarded as development.

(e) Economic growth is multi-dimensional concept which involves not only increase in money income but also improvement in social activities like education, public health, greater leisure etc. Such improvements cannot be measured by changes in per capita real income.

(f) The data of per capita national income are often inaccurate misleading and unreliable because of imperfections in national income data, and its computation. That way, per capita real income cannot be free from weaknesses. Despite these drawbacks in the measure of real per capita income, many countries have adopted this measure as an indicator of economic development.

3. Economic Welfare as an Index of Economic Development:

Keeping in view the drawbacks of real national income and real per capita measures of economic development, some economists like Coline Clark, Kindleberger, D. Bright Singh, Hersick etc. suggested economic welfare as the measure of economic development.

The term economic welfare can be understood in two ways:

(a) When there is equal distribution of national income among all the sections of the society. It raises economic welfare.

(b) When the purchasing power of money goes up, even then there is an increase in the level of economic welfare. The purchasing power of money can go up when with the increase in national income there is also increase in the prices of goods. That means economic welfare can increase if price stability is ensured.

Thus, economic welfare can boost with equal distribution of income and price stability. Higher the level of economic welfare, higher will be extent of economic development and vice-versa.

- ✓ **Arguments against Welfare Index:**

In order to assess economic welfare, it is essential to know the nature of national income and the social cost of production. We face lot a practical difficulty while estimating these economic factors. It is on account of this reason that many economists do not consider economic welfare as a good measure of economic development. Also, the concept of welfare is subjective in nature which cannot be measured. Also, welfare is a relative term which differs from person to person.

4. Measurement through Occupational Pattern:

The distribution of working population in different occupations is also regarded as a criteria for the measurement of economic development. Some economists regard the changes in the occupational structure as a source for measuring the nature of economic development. According to Colin Clark there is deep relation between the occupational structure and economic development. He has divided the occupational structure in three sectors.

(1) Primary Sector:

It includes agriculture, fisheries, forestry, mining etc.

(2) Secondary Sector:

It consists of manufacturing, trade, construction etc.

(3) Tertiary Sector:

It includes services, banking, transport, etc. In under-developed countries, majority of the working population in engaged in primary sector. On the contrary, in developed countries the majority of the working population works in tertiary sector.

A shift in occupational distribution of population from primary sector to secondary and territory sectors shows the movement towards economic development when a country makes economic progress, its working population begins to shift from primary sector to secondary and tertiary sectors. Thus, with economic development the percentage of population engaged in primary sector declines, while the percentage of population working in secondary and tertiary sectors increases.

Here we should note that the measurement of economic development through occupational patterns is not considered as satisfactory on following grounds:

(i) It is not possible to clearly classify the occupations in an underdeveloped economy in three distinct categories

(ii) Secondly, in the early stages of development, the activities of tertiary sector like transport, communications, trade etc. are inadequate and insufficient. Consequently, the chances of employment in these activities are very restricted.

5. Human development index

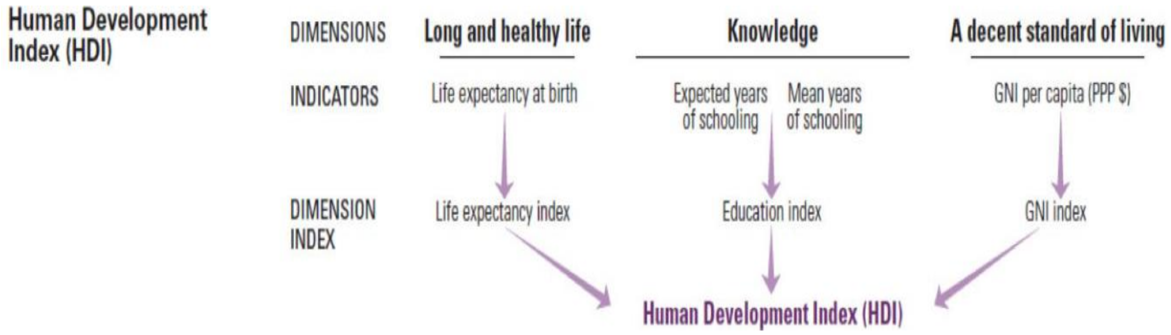
The Human Development Index (HDI) is a measure of economic development and economic welfare. The Human Development Index examines three important criteria of economic development (life expectancy, education and income levels) and uses this to create an overall score between 0 and 1.

- 1 indicates a high level of economic development,
- 0 a very low level.

The HDI combines:

1. Life Expectancy Index. Average life expectancy compared to a global expected life expectancy.
2. Education Index
   1. mean years of schooling
   2. expected years of schooling
3. Income Index (GNI at PPP)

Components of the Human Development Index



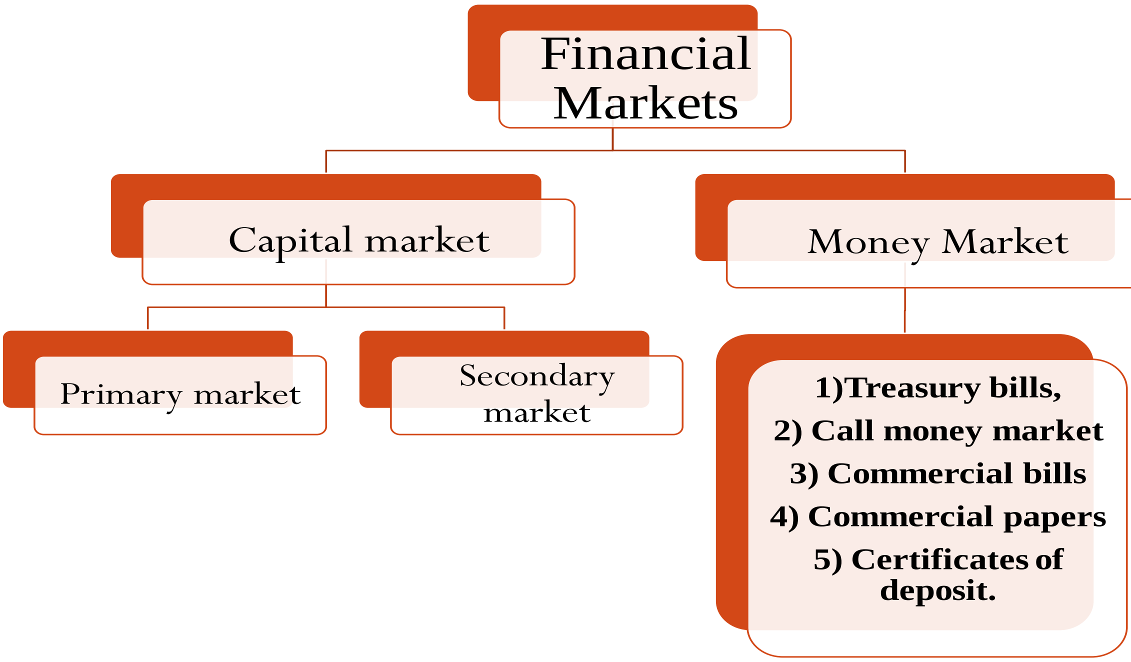
What the HDI shows

- The HDI gives an overall index of economic development. It has some limitations and excludes several factors that might have been included, but it does give a rough ability to make comparisons on issues of economic welfare – much more than just using GDP statistics show.

Limitations of Human Development Index

- Wide divergence within countries. For example, countries like China and Kenya have widely different HDI scores depending on the region in question. (e.g. north China poorer than south-east)
- HDI reflects long-term changes (e.g. life expectancy) and may not respond to recent short-term changes.
- Higher national wealth does not indicate welfare. GNI may not necessarily increase economic welfare; it depends on how it is spent. For example, if a country spends more on military spending – this is reflected in higher GNI, but welfare could actually be lower.
- Also, higher GNI per capita may hide widespread inequality within a country. Some countries with higher real GNI per capita have high levels of inequality (e.g. Russia, Saudi Arabia)
- However, HDI can highlight countries with similar GNI per capita but different levels of economic development.
- Economic welfare depends on several other factors, such as – threat of war, levels of pollution, access to clean drinking water e.t.c.

Chapter 3
Financial Markets



Financial markets:

- Financial markets are the centres or arrangements that provide facilities for buying & selling of financial claims & services. A financial market can be defined as the market in which financial assets are created or transferred. The place where people and organizations wanting to borrow money are brought together with those having surplus funds is called financial market.It may or may not have a particular physical existence. The participants in the financial markets are corporations, financial institution, individual & the government.These participants trade in financial products in these markets. They trade either directly or through brokers & dealers.
- **Financial market is classified in following broad category:**
- **1). Money Market.**
- **2). Capital Market.**

- **<u>1). Money market:</u>**

- A market where short-term funds are borrowed & lent is called money market.
- Money market deals in the short-term assets (with a period of maturity of one year or less than one year) which are near substitutes for money.

- Examples of money market are Treasury bills, Call money market, Commercial bills, Commercial papers, Certificates of deposit. It provides an avenue for equilibrating the short-term surplus funds of lenders and the requirements of borrowers. Short term Money market is the focal point of monetary policy actions.

- **2). Capital market:**

- Capital market is a market for long term securities. It contains financial instruments of maturity period exceeding one year.
- It involves long term nature of transaction.
- Capital market is the financial pillar of industrialized economy.
- The development of nation depends upon the functions and capabilities of the capital market.
- The stock market, government bonds markets, derivatives markets are the example of capital market.

Difference between Capital and Money Market

Basis	Capital Market	Money Market
Participants	Financial Institutions, Banks, Corporate Entities, foreign investors and individuals.	RBI, Banks Institutions and finance companies.
Instruments traded	Equity shares, bonds preferences and debentures, call money etc.	Treasury Bills, Trade Bills commercial paper
Investment Outlay	Does not necessarily require a huge financial outlay.	Entails huge sum of money as the instruments are quite expensive.
Duration	Deals in medium and long term securities having a maturity period of one year.	Deals in short term funds having a maturity period upto one year.
Liquidity	Securities are less liquid as money market securities.	Money markets instruments are highly liquid
Expected	High return	Low return
Safety	Capital Market Instruments are riskier both with respect to return and repayment.	Money market instruments are generally much safer with a minimum risk of default.

❖ Capital market is classified in two categories:

a). Primary market/ New Issue Market (NIM):

- Primary market can be defined as " a market where new securities are bought and sold for the first time."
- Primary market is also known as new issue market. As in this market securities are sold for the first time, i.e., new securities are issued from the company.
- Primary capital market directly contributes in capital formation because in primary market company goes directly to investors and utilises these funds for investment in buildings, plants, machinery etc.
- The common securities issued in primary market are equity shares, debentures, bonds, preference shares and other innovative securities.
- Whenever a company issues new shares or debentures, it is known as Initial Public Offer (IPO).

b). Secondary market:

- The secondary market is the market for the sale and purchase of previously issued or second hand securities. It is a market for already issued securities.
- In secondary market securities are not directly issued by the company to investors. The securities are sold by existing investors to other investors.
- Secondary market does not create any additional funds directly to the corporate sector.
- In secondary market there is no capital formation but secondary market indirectly contributes in capital formation by providing liquidity to securities of the company.
- The most important feature of the secondary market is to create liquidity in securities. Liquidity means immediate conversion of securities into cash. This job is performed by the secondary market.
- In secondary market trading takes place through the registered stock exchanges. In India we have three prominent stock exchanges. They are the Bombay Stock Exchange (BSE), the National Stock Exchange (NSE) and Over The Counter Exchange of India (OTCEI).
- **Debt Instruments, Equities (also called Common Stock), Preference Shares, Derivatives are the instruments traded in secondary market.**

Difference between Primary Market and Secondary Market

Basis	Primary Market	Secondary Market
Securities	Only new securities are traded	Existing securities are traded
Price of Securities	Prices of securities are determined by the management of the company.	Prices are determined by the forces by the demand and supply of the securities.
Purchase and Sale	Securities are sold to investors directly by the company or through intermediary.	Investors exchange ownership of securities.
Place of Market	There is no fixed geographical location.	Located at specified places.
Medium	Only buying of securities takes place.	Both buying and selling of securities can take place.

❖ FINANCIAL INSTRUMENTS:

- Financial instruments are those instruments which are used for raising resources for corporate entities.
- The financial instruments may be capital market instruments or money market instrument.
    - ❖ **1). Money Market Instrument:** the financial instruments which are used for raising & supplying money in a short period not exceeding one year through various securities are called money market instruments.

- Following are some money market instrument:
- 1. Treasury Bills
- 2.Call money/ notice money.
- 3. Commercial bills.
- 4. Commercial Papers
- 5. Certificate of Deposit
- Money market Instruments:

- **Treasury Bills**: To raise short term funds treasury bills are issued by Government. It is purchased by Commercial Banks. At present, Government issues 91 days and 364 days treasury bills.

- **Call Money**: A loan which is taken or given for a very short period, that is for one day is called Call Money Market. It involves lending and borrowing of money on a daily basis. No security is required for these very short-term loans.

- **Commercial Bill Market** (CBM): This market deals with Bills of exchange. The drawer of the bill can get the bills discounted with Commercial Banks. The Commercial Banks can get the bills rediscounted with Financial Institutions.

- **Commercial Paper** (CP): Commercial paper is issued by companies who are listed on Stock Exchange. CP is issued at discount and repaid at face value. The maturity period ranges from 7 days to one year. CP's are issued in multiple of 5 lakh. The company issuing CP must have tangible net worth of at least 4 crore.

- **Certificate Of Deposit** (CD): CD's are used by Commercial Banks and Financial Institutions to raise finance from the market. The maturity period for CD's is between 7 days to 1 year. CD's is issued at a discount and repaid at face value. CD's is issued for a minimum of 25 lakhs.

- **2). Capital market instrument:** The financial instruments that are used for raising capital through the capital market are known as capital market instruments.

- **1. Equity shares (instrument of ownership):** Equity shares are instruments issued by companies to raise capital and it represents the title to the ownership of a company. You become an owner of a company by subscribing to its equity capital (whereby you will be allotted shares) or by buying its shares from its existing owner(s). A person earns from shares is company make profit which is distributed among shareholders know as dividend and if company make loss value of share also falls so shares are high risk instruments.

- **2. Bond or Debt Instrument:** Bond market is also known as Debt market. A debt instrument is used by government or organization to generate funds for longer duration. The relation between person who invest in debt instrument is of lender and borrower. This gives no ownership right. A person receives fixed rate of interest on debt instrument.

- **3). Government debt:** Government securities (G-Secs) are instruments issued by Government of India to raise money. G Secs pays interest at fixed rate on specific dates on half-yearly basis. It is available in wide range of maturity, from short dated (one year) to long dated (up to thirty years). Since it is sovereign borrowing, it is free from risk of default (credit risk). We can subscribe to these bonds through RBI or buy it in stock exchange.

- **4). Derivatives:** are fundamentally contingent contracts/ instruments whose values are derived from some underlying instruments like currency, bonds, stock indices, interest rates, commodities etc. There are generally three main players involved in a derivative transaction: Hedgers, Traders and Speculators. Foreign exchange derivatives (forward, foreign exchange swap, currency swap, currency options) Interest rate derivatives (forward rate agreement, interest rate swap, interest rate options, interest rate caps/ floor/ collar) Equity and stock index derivatives.

➢ Functions of financial Markets / system

- 1. Mobilizing saving:
- 2. Promoting Investment:
- 3. Encouraging Investment in Financial assets:
- 4. Allocating Savings on the basis of national priorities:
- 5. Creating Credit:
- 6. Providing a Spectrum of financial assets:
- 7. Financing Trade, Industry & Agriculture.
- 8. Encouraging Entrepreneurial talents.
- 9. Providing Financial Services.
- 10. Developing backward areas.
- The financial system plays a significant role in the process of economic growth & development of a country.The financial system comprises of a network of commercial banks, Non- banking companies, development banks & other financial & investment institutions offer a varieties of financial products & services to suit varied requirements of different categories of people.
- Financial System plays a crucial role in economic growth & development in the following ways :
- **1. Mobilizing saving:** The financial system mobilizes the savings of the people by offering appropriate incentives & by deepening & widening the financial structure. In other words, the financial system creates varieties of forms of savings so that savings can take place according to the varying asset preferences of different classes of savers. In the absence of the financial system all savings would remain idle in the hands of the savers & they would not have flown into productive ventures.
- **2. Promoting Investment:** For the economic growth of any nation investment is absolutely essential. This investment has to flow from the financial system. In fact, the level of investment determines the increase in output of goods & services & incomes in the country. The financial system collects the savings & channels them into investment which contributes positively towards economic development.
- **3. Encouraging Investment in Financial assets:** The dynamic role of the financial system in the economic development is that it encourages savings to flow into financial assets (money & monetary assets) as against physical assets (land , gold , goods & services). The investments in physical assets are speculative & would breed inflation. On the other hand investment in financial assets are non – inflationary in nature & would aid growth in the economy. **The larger the proportion of the financial assets, the greater is the scope for economic growth in the long- run.**
- 4**. Allocating Savings on the basis of national priorities:** Financial system allocates the savings in a more efficient manner so that the scarce capital may be more efficiently utilized among the various alternative investments. In other words it gives preference

to certain sectors, from the social & economic point of view on the basis of national priorities.

- 5**. Creating Credit:** Large financial resources are needed for the economic development of a nation. These resources are supplied by the financial system not only in the form of liquid cash but also in the form of created money or deposit money by creating credit, & there by making available large resources to finance trade , production, distribution etc. Thus it accelerates economic growth by facilitating the transactions of trade, production & distribution on a large scale.

- **6. Providing a range/variety of financial assets:** The financial system provides a variety of financial assets so as to meet the varied requirements & preferences of households thus it enables them to choose their asset portfolios in such a way as to achieve a preferred mix of return, liquidity & risk. Thus it contributes to the economic development of a country.

- **7. Financing Trade, Industry & Agriculture:** All the financial institutions operating in a financial system take all efforts to ensure that no worthwhile project be it in trade or agriculture or industry- suffers due to lack of funds. Thus they promote industrial & agricultural development which have a greater say on the economic development of a country.

- **8. Encouraging Entrepreneurial talents:** The financial institutions encourage the managerial & entrepreneurial talents in the economy by promoting the spirit of enterprise & risk taking capacity. They also furnish the necessary technical consultancy services to the entrepreneurs so that they may succeed in their innovative ventures.

- **9. Providing Financial Services:** Sophistication & innovations have started appearing in the area of financial intermediation as well. The financial institutions play a very important role in the economic development of a country not only as a provider of finance but also as a departmental store of finance by offering varieties of innovative financial products & services to meet the ever – increasing demands of their clients both corporate & individuals.

- **10. Developing backward areas:** The integral policy of the national development plans of every country concentrates on the development of relatively less develop areas called backward areas. The financial institutions provide a package of services, infrastructure & incentives conducive to a healthy growth of industries in such backward areas & thus they contribute for the uniform development of all regions in a country.

❖ Participants in Financial Markets

1. Banks: Banks participate in the capital market and money market. Within the capital market, banks take active part in bond markets. Banks may invest in equity and mutual funds as a part of their fund management. Banks take active trading interest in the bond market and have certain exposures to the equity market also. Banks also participate in the market as clearing houses.

2. Primary Dealers (PDs): PDs deal in government securities both in primary and secondary markets. Their basic responsibility is to provide two-way quotes and act as market makers for government securities and strengthen the government securities market.

3. Financial Institutions (FIs) FIs provide/lend long term funds for industry and agriculture. FIs raise their resources through long-term bonds from financial system and borrowings from international financial institutions like International Finance Corporation (IFC), Asian Development Bank (ADB) Inter-national Development Association (IDA), International Bank for Reconstruction and Development (IBRD), etc.

4. Stock Exchanges: A Stock exchange is duly approved by the Regulators to provide sale and purchase of securities by "open cry" or "on-line" on behalf of investors through brokers. The stock exchanges provide clearing house facilities for netting of pay-ments and securities delivery. Such clearing houses guarantee all payments and deliveries. Securities traded in stock exchanges include equities, debt, and derivatives. Currently, in India, only dematerialized securities are allowed to be traded on the stock exchanges. Settlement in securities account is made by deposito-ries through participants' accounts. It is essential that stock ex-changes are corporatized and de-mutualised so that there can be greater transparency in the trades and better governance in markets.

5. Brokers: Only brokers approved by Capital Market Regula-tor can operate on stock exchange. Brokers perform the job of intermediating between buyers and seller of securities. They help build up order book, price discovery, and are responsible for a contract being honoured. For their services brokers earn a fee known as brokerage.

6. Investment Bankers (Merchant Bankers): These are agen-cies/organisations regulated and licensed by SEBI, the Capital Markets Regulator. They arrange raising of funds through equity and debt route and assist companies in completing various for-malities like filing of the prescribed document and other compli-ances with the Regulator and Regulators. They advise the issuing company on book building, pricing of issue, arranging registrars, bankers to the issue and other support services. They can under-write the issue and also function as issue managers. They may also buy and sell on their account. As per regulatory stipulations, such own account business should be separately booked and confined to scrip's where insider information is not available to the invest-ment/merchant banker. Investment/Merchant banking can be an exclusive business. A bank can also undertake these activities.

7. Foreign Institutional Investors (FIIs): FIIs are foreign based funds authorized by Capital Market Regulator to invest in coun-tries' equity and debt market through stock exchanges. They are allowed to repatriate sale proceeds of their holdings, provided sales have been made through an authorized stock exchange and taxes have been paid. FIIs enjoy de-facto capital account convert-ibility

FII operations provide depth to equity and debt markets and result in increased turnover. In India, these activities have brought in technological advancements and foreign funds in equity and debt market.

8. Custodians: Custodians are organizations which are allowed to hold securities on behalf of customers and carry out operations on their behalf. They handle both funds and securities of Qualified Institutional Borrowers (QIBs) including FIIs. Custodians are supervised by the Capital Market Regulator. In view of their position and as they handle the payment and settlements, banks are able to play the role of custodians effectively. Thus most banks perform the role of custodians.

9. Depositories: Depositories hold securities in demat (elec-tronic) form, maintain accounts of depository participants who, in turn, maintain accounts of their customers. On instructions of stock exchange clearing house, supported by documentation, a depository transfers securities from buyers to sellers' accounts in electronic form. Depositories are important for ensuring effi-ciency in the market. They facilitate lending against securities and ensure avoidance of settlement risk or bad delivery.

❖ Role of Stock Exchanges and stock indices

Stock Exchange/Share Market

A Stock Exchange is an institution which provides a platform for buying and selling of existing securities. It facilitates the exchange of a security i.e. share, debenture etc. into money and vice versa. Following are some of the important functions of a Stock Exchange:

a. Gives liquidity and marketability to existing securities

b. Pricing of securities (dd and ss)

c. Safety of transactions (membership = regulated + dealings well defined)

d. Contributes to economic growth (ensures that savings are channelized to most productive investment avenues)

e. Spreading of equity cult(ensures wider share ownership)

f. Provides scope for speculation (in a restricted and controlled environment)

➢ What Are Stock Indices?

A stock market index is a statistical measure which shows changes taking place in the stock market. To create an index, a few similar kinds of stocks are chosen from amongst the securities already listed on the exchange and grouped together.

The criteria of stock selection could be the type of industry, market capitalisation or the size of the company. The value of the stock market index is computed using values of the underlying stocks. Any change taking place in the underlying stock prices impact the overall value of the index. If the prices of most of the underlying securities rise, then the index will rise and vice-versa.

In this way, a stock index reflects overall market sentiment and direction of price movements of products in the financial, commodities or any other markets.

Some of the notable indices in India are as follows:

- Benchmark indices like NSE Nifty and BSE Sensex
- Broad-based indices like Nifty 50 and BSE 100
- Indices based on market capitalization like the BSE Smallcap and BSE Midcap
- Sectoral indices like Nifty FMCG Index and CNX IT

➢ **Why are stock indices required?**

The stock market index acts like a barometer which shows the overall conditions of the market. They facilitate the investors in identifying the general pattern of the market. Investors take the stock market as a reference to decide about which stocks to go for investing.

The following lists the importance of stock market index:

1. Aids in Stock-Picking In a share market, you would thousands of companies listed on the exchange. Broadly, picking the appropriate stock for investment may seem like a nightmare. Without a benchmark, you may not be able to differentiate between the stocks. Simultaneously sorting the stocks becomes a challenge. In this situation, a stock market acts like an instant differentiator. It classifies the companies and their shares based on key characteristics like the size of company, sector, industry type and so on.

2. Acts as a Representative: Investing in equities involves risk and you need to take an informed decision. Studying about stocks individually may seem very impractical. Indices help to fill the knowledge gaps that exist among the investors. They represent the trend of the whole market or a certain sector of the market. In India, the NSE Nifty the BSE Sensex act as the benchmark indices. They are believed to indicate the performance of the entire stock market. In the same manner, an index which is made up of pharma stocks is assumed to portray the average price of stocks of companies operating in the pharmaceutical industry.

3. The Parameter for Peer Comparison: Before including a stock in your portfolio, you have to assess whether it’s worth the money. By comparing with the underlying index, you can easily judge the performance of a stock. If the stock gives higher returns than the index, it’s said to have outperformed the index. If it gives lower returns than the index, it’s said to have underperformed the index. You would definitely want to invest in a multibagger so as to justify the risk assumed. Else you can be better off investing in low-cost professionally managed index funds. You may also compare the index with a set of stocks like the Information technology sector. As an investor, you can know market trends easily.

4. Reflects Investor Sentiment: When you are participating in equity markets, amongst other things, knowing investor sentiment becomes an important aspect. It is because the sentiment affects the demand for a stock which in turn impacts the overall price. In order to invest in the right stock, you should know the reason behind the rise/fall in its prices. At this juncture, indices help to gauge the mood of investors. You may even recognize investor sentiment for a particular sector and across market capitalizations.

5. Helps in Passive Investment: Passive investment refers to investing in a portfolio of securities which replicates the stocks of an index. Investors who want to cut down on the cost of research and stock selection prefer to invest in index portfolio. Consequently, the returns of the portfolio will resemble that of the index. If an investor's portfolio resembles the Sensex, then his portfolio is going to deliver returns of around 8% when the Sensex earns 8% returns.

- **Trading Procedure on a Stock Exchange**

1. Selection of Broker: in order to trade on a Stock Exchange first a broker is selected who should be a member of stock exchange as they can only trade on the stock exchange.
2. Placing the order: After selecting a broker, the investors specify the type and number of securities they want to buy or sell.
3. Executing the order: The broker will buy or sell the securities as per the instructions of the investor.
4. Settlement: Transactions on a stock exchange may be carried out on either cash basis or carry over basis (i.e. badla). The time period for which the transactions are carried forward is referred to as accounts which vary from a fortnight to a month. All transactions made during one account are to be settled by payment for purchases and by delivery of share certificates, which is a proof of ownership of securities by an individual. Earlier trading on a stock exchange took place through a public outcry or auction system which is now replaced by an online screen based electronic trading system. Moreover, to eliminate, the problems of theft, forgery, transfer, delays etc. an electronic book entry from a holding

Depository Services and DEMAT Accounts: Keeping in the mind the difficulties to transfer of shares in physical form, SEBI has developed a new system in which trading in shares is made compulsory in electronic form Depository services system and D-Mat Account are very basis of this system.

Depository Services: Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities (e.g., shares, debentures, bonds, mutual funds etc.) in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and instruction to deliver or receive shares on behalf of the investor can be given**.** At present there are two depositories in India: NSDL. (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.). which are known as "Depository Participants". (DPs)

Demat Account

Demat (Dematerialized) account refers to an account which an Indian citizen must open with the depository participant (banks, stockbrokers) to trade in listed securities in electronic form. The securities are held in the electronic form by a depository.

Opening of Demat Account

A Demat account is opened on the same lines as that of a bank account. Prescribed account opening forms available with the DP, need to be filled in. Standard agreement is to be signed by the client and the DP, which details the rights and obligation of both parties. Along with the form, the client is required to attach photograph, attested copies of residence proof and proof of identity need to be submitted.

➢ What is NSE & BSE

Started in 1994, the National Stock Exchange (NSE) is the largest stock exchange in India in terms of total and average daily turnover for equity shares. Being a pioneer in technology, NSE has a fully-integrated business model to provide high-quality data and services to market participants and clients. It includes trading services, exchange listings, indices, market data feeds, clearing and settlement services, financial education offerings and technology solutions. NSE ensures that trading and clearing members and listed companies follow the rules and regulations of the exchange.

Founded in 1875, Bombay Stock Exchange Ltd. (BSE), is the fastest stock exchange in the world which has the speed of 6 microseconds. It provides an efficient, integrated, transparent and secure market for trading in equity, currencies, debt instruments, derivatives, mutual funds. It provides an array of services like clearing, settlement, risk management, education and market data services. It has a global reach with overseas customers and a nation-wide presence. It provides depository services through its Central Depository Services Ltd. (CDSL) arm. The S&P BSE SENSEX is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa).

❖ Securities and Exchange Board of India (SEBI)

SEBI was established by Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was given a statutory status on 30 January1992 through an ordinance which was later replaced by an Act of Parliament known as the SEBI Act, 1992. It seeks to protect the interest of investors in new and second-hand securities.

Objectives of SEBI

1. To regulate stock exchange and the securities market to promote their orderly functioning.
2. To protect the rights and interests of investors and to guide & educate them.
3. To prevent trade mal practices such as internal trading.
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.

<u>Functions of SEBI</u>

1. Protective Functions:

a) Prohibit fraudulent & unfair trade practices in secondary market (e.g. Price rigging & misleading statement).
b) Prohibit insider trading. **c)** Educate investors Promote fair practice & code of conduct in securities market

2.Development Functions: a) Promotes training of intermediaries of the securities market. b) Investor education c) Promotion of fair practices code of conduct of all SRO's. d) Conducting research & publish information useful to all market participants

3. Regulation Functions : a) Registration of brokers and sub brokers & other players in the mkt. b)) Registration of collective investment schemes & mutual funds. c) Regulation of stock bankers & portfolio exchanges & merchant bankers.

************ **End of Unit 4** ************