Economics Class 24

FINANCIAL MARKET (09:00 AM)

- **MONEY MARKET**
- It focuses on short-term borrowing requirements such as working capital. The money market mainly deals with financial instruments whose maturity is up to 1 year.
- Common money market instruments are Treasury bills, Cash management bills, call money, certificates of deposit, commercial paper, commercial bills, etc.
- **Treasury bills**
- These are discounted securities (Non-coupon/ Zero coupons) issued by RBI on behalf of the central government.
- There are three types of treasury bills- 91 days, 182 days, 364 days.
- They are called discounted securities as they are issued at discounted rates and purchased at the original face value.
- **Cash management bills**
- Introduced in 2010, it is a discounted security similar to T-bills with a tenure period of fewer than 91 days.
- **Note**- Stock market performance and bond yields indicate the economic growth situation in a country. Growing Sensex indicates that the market is optimistic and bond yield inversions can indicate an economic fall or recession.
- **Commercial paper-**
- Introduced in 1990, it is a short-term money market instrument issued as an unsecured promissory note and is privately placed.
- They are issued in multiples of 5 lacs.
- Companies, primary dealers, and financial institutions can issue CPs to meet their short-term fund requirements.

- **Commercial bills-**
- These are negotiable instruments drawn by the seller or buyer of goods on the value of goods delivered.
- Trade bills become commercial bills when they are accepted by commercial banks.
- The maximum allowed period is 90 days and these bills are first discounted by commercial banks and then rediscounted by RBI.
- **Certificate of deposit (CD)-**
- It is issued by scheduled commercial banks and selected financial institutions that are permitted by RBI.
- The maturity period is more than 7 days and less than one year.
- All individual residents in India can invest in CDs.
- RBI has increased the minimum denomination for CDs to 5 lac and multiples of 5 lac.
- CDs can be issued in dematerialized form only.
- Banks cannot provide loans against CDs.
- **Call money market-** It is also part of the money market where banks borrow among themselves (inter-bank borrowing) for a short-term period. (1 day)

BOND MARKET (10:00 AM)

- When bond prices increase, bind yield decreases, and bond yield is nothing but the coupon rate divided by the price of the bond.
- **Normal yield curve -** Investing in higher maturity bonds should lead to higher returns.
- **Steep yield curve-** Sudden increase or jump in the yield of long-term bonds.
- **Flat curve-** Irrespective of the maturity it gives the same returns.
- **Inverted yield curve-**When the yield of the long-term maturity bond is less or falling.
- It can be a very strong indicator of recession.

- **Why an inverted yield curve is a strong indicator-** A fall in long-term bond yields indicates increased investments into long-term bonds inflating the prices and thereby, a fall in bond yields i.e. investors are removing money from short-term instruments and investing in long-term instruments (Hedging risk).
- **Impact on India-**
- In the US short-term interest rates are going to increase leading to an appreciation of dollar value.
- The rupee value depreciates in comparison to the dollar making Indian imports costly (oil, food).
- It can have an adverse impact on a macroeconomic indicator like inflation.
- Due to the recession, India may fail to maximize its exports in spite of the falling Rupee value leading to an increase in the trade deficit.
- **Masala Bonds-**
- Before the introduction of masala bonds, companies and financial institutions borrowed by issuing bonds in overseas markets such as the US, and UK in foreign currency because of the easy availability of funds at lower interest rates.
- This exposed the Indian borrowers to foreign currency exchange risks. Depreciation of the Rupee increased their cost of capital/ borrowing.
- Masala Bonds are rupee-denominated bonds that can be issued by entities Such as Governmental bodies, NBFCs, and eligible corporates to raise money from overseas markets.
- In Masala Bonds, the foreign currency exchange rate risks are borne by the international lenders and not the Indian borrowers.

The first Masala bond was issued by international finance corporation in 2014 to raise 1000cr to fund infrastructure projects in India

An Inflation-Indexed Bond (IIB) is a type of bond designed to protect investors from inflation. The principal and interest payments of these bonds are adjusted based on inflation rates, which means they provide a return that keeps pace with inflation. Here are the key features:

Principal Adjustment: The principal amount of the bond is adjusted according to an inflation index, typically the Consumer Price Index (CPI). As inflation rises, the principal amount increases, and as inflation falls, the principal decreases.

Interest Payments: The interest payments are calculated based on the adjusted principal. This means that the interest payments increase with inflation and decrease with deflation.

- **Inflation-Indexed Bond (10:58 am)**
- Inflation-indexed Bond (IIB) provides a constant return irrespective of the level of inflation and protects the investor against macroeconomic risks.
- Initially, IIBs were issued in the name of capital-indexed bonds in 1997.
- The capital-indexed bonds provided inflation protection only to the principal amount and not to the interest payment. However, IIBs provide inflation protection to both principal and interest payments.
- **Zero coupon bond**
- A regular bond pays interest to the bondholder over the life of the bond and repays the principal at the time of maturity.
- However, a zero-coupon bond does not pay interest. The face value of the bond is received by the bondholders after it reaches maturity.
- **Foreign currency convertible bonds**
- It is a bond issued by an Indian company in foreign currency and subscribed by non-residents in foreign currency.
- These bonds can be converted into ordinary shares of the issuing company in part or whole. (which is decided by company)
- FCCB represents a debt obligation of the corporates. Investors have the option to redeem or convert them into underlying local shares of the company or global depository receipts (GDRs). If the investor prefers to hold the FCCB until the redemption date, the corporation has to redeem the FCCB on the redemption date.
- Dilution would take place as and when debt is converted into equity.
- Since these bonds are convertible into equity shares over a period of time as provided in the instrument, they are covered under FDI policy and counted towards FDI. If they are redeemed they count as ECB and debt obligation. Only that portion that is converted into equity is counted towards FDI.

NEGATIVE YIELD BOND (11:51 AM)

- A negative bond yield is when an investor receives less money upon bond maturity than the original purchase price of the bond.
- They are issued by the central banks during times of stress and uncertainty as investors look to protect their capital from significant erosion.

TOPIC OF NEXT CLASS- SHARES AND DERIVATIVES

Dilution in ownership