Second Chapter: Money and Capital Market

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What is the Money Market?

The money market refers to trading in very short-term debt investments. At the wholesale level, it involves large-volume trades between institutions and traders. At the retail level, it includes money market mutual funds bought by individual investors and money market accounts opened by bank customers.

Key Takeaways

- The money market involves the purchase and sale of large volumes of very short-term debt products, such as overnight reserves or commercial paper.
- An individual may invest in the money market by purchasing a money market mutual fund, buying a Treasury bill, or opening a money market account at a bank.

Understanding the Money Market

The money market is one of the pillars of the global financial system. It involves overnight swaps of vast amounts of money between banks and the other countries. The majority of money market transactions are wholesale transactions that take place between financial institutions and companies.

Who are the participants in the Money Market?

1. All commercial banks
2. CB (Central bank)
3. Financial Organizations
4. Government
5. Individuals

Money Market Instruments

1. Deposit
2. Treasury bills

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3. Short term loan
4. Short term bond
5. Commercial paper
6. Repo

Deposit

Most certificates of deposit (CDs) are not strictly money market funds because they are sold with terms of up to 10 years. However, CDs with terms as short as three months to six months are available.

Commercial Paper

The commercial paper market is for buying and selling loans for corporations in need of a short-term cash infusion. Only highly creditworthy companies participate, so the risks are low.

Bankers Acceptances

The banker's acceptance is a short-term loan that is guaranteed by a bank. Used extensively in foreign trade, a banker's acceptance is like a post-dated check and serves as a guarantee that an importer can pay for the goods. There is a secondary market for buying and selling banker's acceptances at a discount.

Repos

The repo, or repurchase agreement (repo), is part of the overnight lending money market. Treasury bills or other government securities are sold to another party with an agreement to repurchase them at a set price on a set date.

Capital Markets

The capital market is dedicated to the sale and purchase of long-term debt and equity instruments. The term "capital markets" refers to the entirety of the stock and bond markets for the long period of time.

Why is the Money Market Important?

The money market is crucial for the smooth functioning of a modern financial economy. It allows savers to lend money to those in need of short-term loans and allocates capital towards its most productive use. These loans, often made overnight or for a matter of days or weeks, are needed by governments, corporations, and banks in order to meet their near-term obligations or regulatory requirements. At the same time, it allows those with excess cash on hand to earn interest.

What is Capital Market?

Capital market where buyer and seller come together for trading long term securities is called a capital market. Securities like stocks and bonds are sold and bought by various institutions, companies, etc.

Capital market is a market where savings and investments are channeled between suppliers—people or institutions with capital to lend or invest—and those in need. Capital markets are composed of primary and secondary markets. The most common capital markets are the stock market and the bond market.

Key Takeaways

- Capital markets refer to the venues where funds are exchanged between suppliers of capital and those who demand capital for use.
- Primary capital markets are where new securities are issued and sold. The secondary market is where previously issued securities are traded between investors.
- The best-known capital markets include the stock market and the bond markets.

Understanding Capital Markets

Capital market is a broad term used to describe the in-person and digital spaces in which various entities trade different types of financial instruments. These venues may include the stock market, the bond market, and the currency and foreign exchange markets. Capital markets are composed of the suppliers and users of funds.

These markets are divided into two different categories: primary markets—where new equity stock and bond issues are sold to investors—and secondary markets, which trade existing securities. Capital markets are a crucial part of a functioning modern economy because they move money from the people who have it to those who need it for productive use.

What are the Types of Capital Market?

The types of capital market – primary and secondary are essential to understand for Commerce students. Additionally, there are other divisions of capital market based on the traded security type - bond market and the stock market.

Herein, we will focus on the former division of capital market types - primary and secondary markets.

- **Primary Market**

Herein, the trading takes place for new securities. Companies go public for the first time in this market that allows entities outside the locus of an organisation to purchase their shares. This phenomenon is called Initial Public Offering or IPO.

- **Secondary Market**

Between the types of capital markets, it deals with securities that have already been traded in the primary market. New York Stock Exchange (NYSE), Bombay Stock Exchange (BSE), National Stock Exchange (NSE), etc. are secondary markets.

To understand these clearly, students should grow an understanding of the types of capital in business as well.

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What are the Functions of the Capital Market?

Irrespective of the capital market and its types, their functions are similar. These are listed below -

- Enhance trading of securities

Provides a common platform to both investors and savers

- Accumulation of capital for companies that need them
- Stimulates economic growth
- It improves the process of allocation of capital
- Prepares for continuity of funds availability
- It reduces mis-information and transaction tax significantly.
- Faster valuation of securities.
- Provides proper channelling of funds to be used productively.

Therefore, the capital market is an effective medium for mobilising funds between investors and sellers. With the functions listed above, it is evident that the capital market is not only a platform for fund transfer but also has its long term advantages.

It is useful in boosting national incomes, thereby enhancing the overall economic growth of a nation as a whole. As a result, you will need to understand the concepts from the grassroots to get an in-depth idea of a capital market meaning and types, functions and significance.

What are the Different Instruments of Capital Market?

The types of capital market instruments are broadly classified into two types -

1. **Equity security**

    a. **Equity shares**

These shares are the prime source of finance for a public limited or joint-stock company. When individuals or institutions purchase them, shareholders have the right to vote and also benefit from dividends when such organisation makes profits. Shareholders, in such cases, are regarded as the owners of a company since they hold its shares.

    b. **Preference shares**

These are the secondary sources of finance for a public limited company. As the name suggests, holders of such shares enjoy exclusive rights or preferential treatment by that company in specific aspects. They are likely to receive their dividend before equity shareholders. However, they do not have any voting rights typically.

2. **Debt security**

    b. **Bonds**

It is a fixed income instrument, primarily issued by sovereign and state governments, municipalities, and even companies to finance infrastructural development and other types of projects. It can be viewed as a loaning instrument, where a bond's issuer is the borrower.

Bondholders are considered as creditors concerning such an entity and are entitled to periodic interest payment. Furthermore, bonds carry a fixed lock-in period. Therefore, issuers of bonds are mandated to repay the principal amount on the maturity date to bondholders.

    c. **Debentures**

Unlike bonds, debentures are unsecured investment options. Consequently, they are not backed by any asset or collateral. Here, lending is entirely based on mutual trust and, herein, investors act as potential creditors of an issuing institution or company.

All these four instruments are parts of the capital market. Since each is unique and has distinguishing features, they are useful in different ways for a company. Therefore, it is crucial to understand the different type of capital market instruments so that you can acknowledge their purposes.

What are the main instruments in Islamic capital market?

Common Shariah principles that are used in Islamic debt instruments include murabahah (trade with mark up or cost plus), ijarah (lease financing), bai` al-salam (advance purchase), istisna` (purchase order) and others.

Structure of the Financial Market

1 Money Market
2. Capital Market

Other types of market are:

3. Future Market
4. Option Market
5. Spot Market

- Futures are derivative financial contracts that obligate the parties to transact an asset at a predetermined future date and price. A futures market is an auction market in which participants buy and sell commodity and futures contracts for delivery on a specified future date.
- Buying and selling options are done on the options market, which trades contracts based on securities. Buying an option that allows you to buy shares at a later time is called a "call option," whereas buying an option that allows you to sell shares at a later time is called a "put option.
- The spot market is where financial instruments, such as commodities, currencies, and securities, are traded for immediate delivery.