Unit – III: Capital Market.

Definition, characteristics and Function

Meaning of Capital market:

Capital markets are financial markets for the buying and selling of long-term debt or long term securities having a maturity-period (age) of one year or more. These markets channel/direct the wealth of savers to those who can put it to long-term productive/useful use, such as companies or governments making long-term investments/capital spending. Financial regulators/watchdogs such as the Securities and Exchange Board of India (SEBI), oversee/direct the capital markets in their jurisdictions/areas to protect investors against fraud/dishonesty among other duties.

Definition of Capital market:

Capital market is a market for long-term funds-both equity and debt-and funds raised within and outside the country.

The capital market aids economic growth by mobilizing the savings and directing the same towards productive use. This is facilitated through the following measures or ways:

1. Issue of 'primary securities' in the primary market,' i.e., directing cash flow from the surplus sector to the deficit sectors such as the government and the corporate sector.
2. Providing liquidity and marketability of outstanding debt and equity instruments.

Features/Characteristics of Capital Market:

1. Link between savers and investors: The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called "Surplus units" and the investors/borrowers are known as "deficit units". The capital market is the transmission mechanism between surplus units and deficit units. It is a conduit through which surplus units lend their surplus funds to deficit units.

2. Deals in Long Term fund: Capital market provides funds for long and medium term. It does not deal with channelizing saving for less than one year.

3. Utilizes Intermediaries: Capital market makes use of different intermediaries such as brokers, underwriters, depositories etc. These intermediaries act as working organs of capital market and are very important elements of capital market.

4. Capital formation: The capital market prides incentives to savers in the form of interest or dividend to transfer their surplus fund into the deficit units who will invest it in different businesses. The transfer of funds by the surplus units to the deficit units leads to capital formation.

5. Government Rules and Regulations: The capital market operates freely but under the guidance of government policies. These markets function within the framework of government rules and regulations, e.g., stock exchange works under the regulations of SEBI which is a government body.

An ideal capital market is one:

1. Where finance is available at reasonable cost.

2. Which facilitates economic growth.

3. Where market operations are free, fair, competitive and transparent.

4. Must provide sufficient information to investors.

5. Must allocate capital productively.

Importance or Functions of Capital Market:

The capital market plays an important role in mobilizing saving and channel them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country. We discuss below the importance of capital market.

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2. Basis for industrialization: Capital market generates long term funds, which are essential for the establishment of industries. Thus, capital market acts as a basis for industrialization.

3. Accelerating the pace of growth: Easy and smooth availability of funds for medium and long period encourages the entrepreneurs to take profitable ventures/businesses in the field of trade, industry, commerce and even agriculture. It results in the all round economic growth and accelerates the pace of economic development.

4. Generating liquidity: Liquidity means convertibility into cash. Shares of the public companies are transferable i.e., in case of financial requirements these shares can be sold in the stock market and the cash can be obtained. This is how capital market generates liquidity.

5. Increase the national income: Funds flow into the capital market from individuals and financial intermediaries which are absorbed by commerce, industry and government. It thus facilitates the movement of stream of capital to be used more productively and profitability to increase the national income.

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7. Productive investment: The capital market provides a mechanism for those who have savings transfer their savings to those who need funds for productive investments. It diverts resources from wasteful and unproductive channels such as gold, jewelry, conspicuous consumption, etc. to productive investments.

8. Stabilization of the value of securities: A well-developed capital market comprising expert banking and non-banking intermediaries brings stability in the value of stocks and securities. It does so by providing capital to the needy at reasonable interest rates and helps in minimizing speculative activities.

9. Encourages economic growth: The capital market encourages economic growth. The various institutions which operate in the capital market give quantities and qualitative direction to the flow of funds and bring rational allocation of resources. They do so by converting financial assets into productive physical assets. This leads to the development of commerce and industry through the private and public sector, thereby encouraging/inducing economic growth.