

# **An Analysis of Financial Markets in India**

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**Abstract:** *In the empirical finance literature, the flow of information between financial markets has received substantial attention. For the financial year 2014-2015, the study's basic data consists of four variables: spot equity index rates, 3 month future equity index rates, repo rate, and dollar/rupee exchange rate. These variables are used to examine the interrelationship between different types of financial markets, namely Capital Market, derivative market, Money Market, and Foreign Exchange market. Using simple regression analysis, this paper attempts to examine the impact of the Equity Spot Market on the Forex, Money, and Index Futures Markets. The outcome reveals that the Spot Market has a substantial effect on the Futures Market, and that the Futures Market is largely dependent on the Spot market. The conclusion of the regression study, however, does not indicate the existence of a notably substantial impact of the Spot Market on the Forex and Money Markets. Using univariate Granger Causality, the study attempted to investigate the causative relationship between Capital Market, Money Market, Forex and Futures Market, but found no indication of a causal relationship between these divisions of the Financial Market*

**Keywords:** Financial Market

## **I. INTRODUCTION**

Financial Market is a system that enables the buying and selling of financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible objects of value at low transaction costs and prices that reflect the efficient-market hypothesis. Typically, financial markets are characterised by transparent pricing, basic laws on trading, expenses and fees, and market forces that determine the prices of traded securities. In economics, the term market often refers to the aggregate of potential buyers and sellers of a certain item or service and their transactions. Financial Markets enable:

- The raising of capital (in the Capital Markets)
- Risk transference (in the Derivatives Markets)
- Transfer of liquid assets (in the Money Markets)
- And are used to match those seeking finance with those with capital

### **The Evolution of Financial Markets in India**

The financial system and infrastructure of a nation at a given period is the product of its own unique historical development. This evolution is modified over time by the interaction between all system participants and public policy initiatives. These policy interventions are also a reflection of the regulators' and governments' views at the time regarding the acceptable and desirable balance between innovation and stability, and between the role of the state and the markets.

The evolution of the Indian financial markets and the regulatory structure have followed a parallel course. In India, for example, the Reserve Bank of India (RBI) initially regulated the banking sector, while the Ministry of Finance regulated all other financial sectors. Presently, the majority of financial service providers and regulatory authorities are in place. Over time, the role of regulators has shifted from that of a tool for planned development in the early stages to that of a referee of a considerably more sophisticated and complicated financial sector.

During this time span, India has implemented a number of financial sector reform policies that have yielded numerous significant achievements. Important to these reforms has been the authorities' attempt to align the regulatory system with international best practises, taking into account the country's needs and domestic considerations. These reforms can be broadly categorised as measures taken to: i. liberalise the macroeconomic and regulatory environment in which

financial sector institutions operate; ii. strengthen the institutions and improve their efficiency and competitiveness; and iii. establish and strengthen the regulatory framework and institutions for overseeing the financial system.

## II. REVIEW OF LITERATURE

Numerous empirical studies analyse the relationships between various financial markets. Numerous researches have focused on the interconnections between financial markets across regional borders and asset classes. One of the objectives for conducting such research is to determine the effect of events on one market on another. In recent years, events such as the 1987 stock market disaster, the Mexican crisis, the Asian currency crisis, etc. have elevated the significance of such studies. Various methodologies, such as cross market correlation coefficients, VAR, co-integration, ARCH and GARCH family of models, GMM, etc., have been employed to investigate these relationships.

Prakash Apte (2001) examined the relationship between the stock market's volatility and India's nominal exchange rate using the E-GARCH model. The study indicated that empirical analysis of one of the major stock market indexes supports the idea of volatility links, whereas for the other index there appears to be a spillover from the foreign currency market to the stock market, but not vice versa.

According to Francis and Hasan (2003), the connections between the equity and currency markets are substantial, bidirectional, and ubiquitous. According to Andersen and Bollerslev (2003), news surprises result in conditional mean jumps; hence, high frequency stock, bond, and exchange rate dynamics are correlated with fundamentals.

According to Badrinath and Apte (2005), there is asymmetric volatility spillover in India's stock, call money, and forex markets. Either the rate of knowledge absorption was delayed, or the spillover was the product of an infectious disease. Kedarnath and Mukherjee (2005) state that although there is a strong contemporaneous and bi-directional relationship between the returns on the spot and futures markets, the spot market has been found to play a relatively stronger leading role in disseminating market information, and is therefore considered more efficient.

Jain & Bhanumurthi (2005): examined the issue of integration of financial markets in India during the post-1991 period using monthly data on call money rates, 91 day Treasury Bill rates, Indian Rupee/US dollar exchange rates, and the London Inter Bank Offered Rate (LIBOR) and found evidences for the existence of strong integration of the domestic call Money Market with the LIBOR and the existence of long-term co- movement between domestic foreign exchange market and the LIBOR.

Jasien & Pakevicius (2009) analysed whether the capital and money markets evolve in parallel, i.e., whether the growth of one market fosters the growth and development of the other, or whether the two markets operate as competitors. The results demonstrate that the current macroeconomic climate ensures the concurrent development and movement of share prices and the overnight interest rate.

Gulathi and Kakhani (2012) evaluated the causative relationship between foreign exchange rates and the stock market using the Granger Causality test and the correlation test, and refuted the existence of such a relationship.

Somasundaram and Muthukumar (2014) evaluated the causality relationship between exchange rate and stock returns using Granger Causality and concluded that neither the exchange rate nor stock returns influence the other.

## III. CATEGORIES OF FINANCIAL MARKET

**Money Market:** This sector of the financial market consists of products with a maturity or redemption date of one year or less at the time of issuance. Typically, these are wholesale markets. Money Market refers to the network of financial institutions that trade in short-term cash via products such as bills of exchange, promissory notes, commercial paper, and treasury bills, among others.

The objective of money markets is to enable the movement of short-term funds from agents with excess funds (corporations, financial institutions, people, and the government) to market participants with insufficient short-term funds. They play a central role in the financial system of the country by influencing it through the monetary authority. Money Markets enable financial organisations and, to a lesser extent, non-financial businesses to carry out the following functions:

- . Fund raising;
- . Cash management;
- . Risk management;

. Position or speculative finance;

. Signaling;

Money Markets are wholesale markets with very large transaction volumes, such as 500 million Euro to 1 billion Euro transactions or even larger ones. This is the most dynamic financial market in terms of trade volume. Since the beginning of emergence, the traditional Money Markets have been responsible for monetary policy.

Governments have employed direct regulation and control of the savings and investment behaviour of individuals and businesses in order to impact the supply side. However, as a result of rapid technical advancements, internationalisation, and deregulation of financial markets, the potential for such approaches to achieve governmental objectives has lessened. Through market-oriented initiatives, the current policy focuses mostly on the demand side. Thus, Money Markets act as the interface between monetary policy implementation and national economies. Public policy objectives, such as financing public sector deficits and managing cumulative government deficits, are yet another function of domestic money markets. Government public debt policy is a significant influence of the functioning of the Money Markets, as government debt often constitutes a significant portion of a country's Money Markets (as well as debt markets). The scope and measures of monetary policy are also tied to the budget and fiscal policies of the government. Thus, the movement of the country's Money Market is contingent upon the objectives of national public policy and the methods employed to achieve these objectives.

Capital Market: The Capital Market is the segment of the financial market where firms and governments trade long-term financial securities. In this context, "long-term" refers to financial instruments with an original maturity greater than one year, as well as perpetual securities (those with no maturity). There are two sorts of Capital Market securities: those that represent ownership interests, commonly known as equity, and those that are issued by corporations.

The Capital Markets can be divided into cash market and derivative market categories.

The cash market, also known as the Spot Market, is the market for the instantaneous purchase and selling of a financial instrument.

Derivative market: Some financial instruments on the derivatives market stipulate that the contract holder has either the obligation or the option to acquire or sell another asset at or by a future date. The underlying refers to the "something" that is the subject of the contract (asset). A stock, bond, financial index, interest rate, currency, or commodity is the underlying asset. Because the value of these contracts is derived from the value of the underlying assets, they are referred to as derivative instruments, and the market in which they are exchanged is known as the derivatives market.

Foreign Exchange Market: It is a market where people purchase, sell, trade, and speculate with currencies. It consists of banks, businesses, central banks, investment management firms, hedge funds, retail Forex brokers, and investors. It is considered the largest market in the world.

The currency markets are thought to be the most efficient financial markets due to their size and liquidity. Foreign exchange markets facilitate currency conversion, hence facilitating international trade and investment. For instance, it allows a business in the United States to import items from European Union member states in Euros even though its revenue is in US dollars. It also facilitates direct speculation and evaluation of the currency's worth, as well as trade speculation based on the interest rate differential between two currencies.

The foreign exchange market is distinctive due to the following features:

- Its enormous trading volume, being the world's largest asset class, results in high liquidity.
- Its geographic distribution
- It operates 24 hours a day, seven days a week, with the exception of weekends, trading from 22:00 GMT on Sunday (Sydney) to 22:00 GMT on Friday (New York)
- The diverse factors that influence exchange rates
- The low relative profit margin compared to other fixed income market.
- Due to the use of leverage to increase the profit and loss margin and account size, the market has been described as being closer to ideal competition, despite currency intervention.

#### IV. CONCLUSION

Using simple regression analysis, this paper attempts to examine the impact of the Equity Spot Market on the Forex, Money, and Index Futures Markets. The outcome reveals that the Spot Market has a substantial effect on the Futures

Market, and that the Futures Market is largely dependent on the Spot market. The conclusion of the regression study, however, does not indicate the existence of a notably substantial impact of the Spot Market on the Forex and Money Markets. Using univariate Granger Causality, the study attempted to investigate the causative relationship between Capital Market, Monet Market, Forex and Futures Market, but found no indication of a causal relationship between these divisions of the Financial Market. This may be owing to the limited duration of the time series data (only one year). If the time period for studying the link is extended, then a sound and conclusive conclusion could be reached.

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