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Financial Institutions and Markets

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Sample Preview
of the
Solved
Sample Question
Papers

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QUESTION PAPER

June – 2023

(Solved)

FINANCIAL INSTITUTIONS AND MARKETS

M.E.C.E.-4

Time: 3 Hours] *[Maximum Marks: 100*

Note: *Attempt questions from each section as per instructions given.*

SECTION-A

(Long-Answer Questions)

Note: Answer any *two* questions from this section.

Q. 1. What are the main components of a financial system? What are the functions of a financial system in the economic development of a country?

Ans. Ref.: See Chapter-1, Page No. 7, Q. No. 1 and Page No. 4, 'Functions of the Financial Systems in the Process of Economic Development'.

Q. 2. What are the various ways in which companies raise finance? Discuss the main issues regarding the capital structure of firms.

Ans. Ref.: See Chapter-4, Page No. 45, 'Debt and Equity as a Means of Raising Finance'.

Q. 3. Explain the concept of an option as a financial asset. Discuss the Black-Scholes' model of pricing of options. What are its limitations?

Ans. Ref.: See Chapter-7, Page No. 54, 'Options' and Page No. 57, 'The Black Scholes Formula', 'Limitation'.

Q. 4. Discuss Milton Friedman's modern quantity theory of money and compare it with Keynes' theory of demand for money.

Ans. Ref.: See Chapter-13, Page No. 93, 'Money and Nominal Income: Quantity Theory of Money', Page No. 95, 'Comparison Between Keynesian and Friedman Perspective'.

SECTION-B

(Short Answer Type Questions)

Note: Answer any *five* questions from this Section.

Q. 5. Discuss the main functions of investment banks.

Ans. Ref.: See Chapter-11, Page No. 84, Q. No. 1.

Q. 6. Explain the nature of futures as a financial derivative. How does it help in risk management?

Ans. Ref.: See Chapter-12, Page No. 91, Q. No. 5.

Q. 7. Explain the nature and significance of money supply using the money multiplier process.

Ans. Ref.: See Chapter-13, Page No. 96, 'The Money Supply Process', Page No. 97, 'Money Multiplier Model'.

Q. 8. Explain the need and role of depository system in secondary financial markets.

Ans. Ref.: See Chapter-8, Page No. 64, 'Depository System'.

Q. 9. Distinguish between the expectations, hypothesis and the market segmentation hypothesis for the explanation of the 'term structure of interest rates'.

Ans. Ref.: See Chapter-4, Page No. 36, Q. No. 8.

Q. 10. Bring out the salient features of the Capital Asset Pricing Model (CAPM).

Ans. Ref.: See Chapter-3, Page No. 21, 'Capital Asset Pricing Model'.

Q. 11. What advantages do flexible exchange rates have over fixed ones?

Ans. Flexible exchange rates, also known as floating exchange rates, and fixed exchange rates represent two different systems by which countries value and exchange their currencies. Each system has its advantages and disadvantages. Here are some advantages of flexible exchange rates over fixed ones:

1. Automatic Adjustment to Economic Shocks:

- **Flexible Rates:** Under a flexible exchange rate system, currency values fluctuate based on market forces like supply and demand. This allows the currency to automatically adjust to economic shocks. For instance, if a country faces a recession, its currency might depreciate, making its exports cheaper and imports more expensive, which can help boost economic recovery.

- **Fixed Rates:** In a fixed exchange rate system, currencies are pegged to a specific value (usually another currency like the US dollar) and don't adjust to market conditions. This lack of adjustment can create economic imbalances, leading to trade deficits or surpluses, as the currency doesn't reflect the country's economic realities.

2. Monetary Policy Independence:

- **Flexible Rates:** Countries with flexible exchange rates have greater control over their domestic monetary policies. They can adjust interest rates and money supply to manage inflation, unemployment, and economic growth without being constrained by the need to maintain a specific exchange rate.
- **Fixed Rates:** Countries with fixed exchange rates must adjust their domestic policies to maintain the pegged rate. This can limit their ability to use monetary policy tools for domestic economic stability, as changes in interest rates might be necessary to defend the fixed rate.

3. Market Efficiency and Information:

- **Flexible Rates:** Floating exchange rates are determined by market forces, reflecting a country's economic fundamentals and market perceptions. This provides real-time information to policymakers, businesses, and investors, allowing them to make decisions based on the most current economic conditions.
- **Fixed Rates:** Fixed exchange rates can create situations where the market value of a currency differs significantly from its pegged value. This divergence can lead to speculative attacks on the currency, as traders bet on the need for the government to adjust its policy, potentially causing market instability.

4. Preventing Currency Speculation:

- **Flexible Rates:** In a flexible system, since the currency's value adjusts according to market demand, speculative attacks are less likely to occur. Market participants are less inclined to bet against a currency if they know the government won't deplete its foreign reserves defending an unrealistic fixed rate.
- **Fixed Rates:** Fixed exchange rates are vulnerable to speculative attacks, especially if the market perceives that the fixed rate is unsustainable. Speculators can sell the currency short, betting on its devaluation, which can force a country to deplete its foreign reserves defending the fixed rate.

5. Avoiding Currency Crises:

- **Flexible Rates:** Countries with floating exchange rates are generally less susceptible to currency crises. Their currencies can adjust to market pressures, mitigating the risk of sudden and severe currency devaluations.
- **Fixed Rates:** Fixed exchange rate systems are more prone to currency crises. If a country's economic fundamentals don't support the fixed rate, it can lead to a speculative attack, depleting the country's reserves and potentially triggering a financial crisis.

In summary, flexible exchange rates offer countries greater economic stability, policy independence, and resilience against market shocks. However, it's important to note that each system has its trade-offs, and the choice between flexible and fixed exchange rates often depends on a country's economic goals, stability, and policy preferences.

Q. 12. Discuss the role of SEBI in the Indian Financial Market.

Ans. Ref.: See Chapter-8, Page No. 60, 'Securities and Exchange Board of India (SEBI)'.

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Sample Preview
of
The Chapter

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FINANCIAL INSTITUTIONS AND MARKETS

NATURE AND ROLE OF FINANCIAL SYSTEM

The Role of Financial Markets in the Economy

1

INTRODUCTION

Money, credit and finance are related but somewhat different and all three are connected with financial markets. Financial system is a set of complex and closely connected or inter-mixed institutions in the economy.

Economists have given varied opinions on the role of financial system in economic development. Bagehot and Schumpeter viewed that an efficient financial system is of great relevance for an economy to operate efficiently. Ross Levine has pointed out that well functioning financial system help in technological innovation by offering funding to entrepreneurs who have innovative abilities.

But recently, there has been a change in the opinions of economists in this regard. Joan Robinson has viewed that economic growth creates demand for financial institutions. It means first economic development takes place and then financial sector development follows. Similarly, Robert Lucas has stated that economists "badly over-stress" the role of financial institutions in economic growth.

However, in recent years, on theoretical side many complex models have been developed for understanding relation between economic growth and financial markets. These channels include the facilitation of:

(a) Trade Hedging,
(b) Diversifying,
(c) Pooling of risk,
(d) Efficient utilization of resources
(e) Mobilization of savings, and
(f) Monitoring of managers and exerting corporate control.

On empirical side, a strong correlation has been observed between financial sector growth and economic growth.

CHAPTER AT A GLANCE

NATURE OF FINANCIAL SYSTEM

A financial system is a set of complex, and inter-connected institutions, agents, practices, markets, transactions and claims and liabilities in the economy.

It has four constituents:

(a) Financial Institutions

(b) Financial Markets

(c) Financial Instruments

(d) Financial Services

Financial Institutions

Financial institutions are mobilizers and depositors of savings and providers of credit and loans. Financial institutions can be classified into:

(a) Banking institutions and Non-Banking Institutions.

(b) Intermediaries and Non-Intermediaries.

Banking Institutions and Non-Banking Institutions

Basis	Banking Institutions	Non-Banking Institutions
Meaning	Banking institutions accept demand deposits i.e. they accept deposits that can be used for payments and transactions motive.	Non-Banking institutions do not accept demand deposits i.e. they do not accept deposits that can be used for payments and transactions motive.
Share in Money Supply	Deposits of banking are a major source of money supply in the economy.	They provide a minor source of money supply.
Credit	Banking institutions are creators of credit.	Non-Banking institutions are purveyors of credit.
Intermediaries	They are always financial intermediaries.	They may be financial intermediaries or non-financial intermediaries.

Intermediaries and Non-Intermediaries

Basis	Intermediaries	Non-Intermediaries
Meaning	They mediate between investors and savers.	These institutions do the loan business but their money is not directly received from savers.
Function	They lend money as well as mobilize savings.	They only lend money.
Assets and Liabilities	Their liabilities are towards the ultimate savers and their assets are from borrowers.	Their liabilities are not specifically known but their assets are investors.
Who are who	All banking institutions are financial intermediaries.	Non-Banking institutions may be in intermediaries or non-intermediaries. When they are non-intermediaries, they are called non-banking financial intermediaries.

Financial Markets

It is a market in which people deal in financial securities like shares, debentures etc. Demand and supply of such securities determine their price.

Financial markets can be classified into:

(a) Primary and Secondary Markets

(b) Money Market and Capital Market

However, financial markets are also classified into:

(i) Organized and unorganized,

(ii) Formal and informal,

(iii) Official and parallels,

(iv) Domestic and foreign.

Primary Market and Secondary Market

Basis	Primary Market	Secondary Market
Meaning	It deals in new financial claims or new securities	It deals in securities which are already issued or existing or outstanding.
Function	It mobilizes savings and savings supply fresh or additional capital to business units.	Secondary markets do not directly contribute to the supply of additional capital. Their role is to making primary markets liquid.
Other name	They are also called "New Issue Markets"	They are also called "Old Markets".

Money Market and Capital Market

Basis	Money Market	Capita Market
Meaning	Money market is a short-term market for short-term securities with a maturity of less than one year.	Capital market is a market for long-term securities which have maturity period of one year or more.
Purpose	It provides funds for working capital.	It provides funds for long-term.

Financial Instruments

A financial instrument can be defined as a claim against either a person or an institution for the payment on a future date. Payment may be a lump sum amount or a periodic amount like interest or dividend. Financial securities vary from each other in terms of:

(i) Marketability liquidity reversibility,
(ii) Types of options,
(iii) Returns,
(iv) Risks involved, and
(v) Transaction costs

These instruments can be primary securities or secondary securities.

Primary Securities and Secondary Securities

Basis	Primary Securities	Secondary Securities
Meaning	These are directly issued by the ultimate borrowers of funds to ultimate user.	Secondary securities are securities issued by intermediaries.
Other name	These are also called direct securities.	They are also called indirect securities.

Financial Services

Financial services include merchant banking, leasing, hire purchase, credit rating, etc. these are performed by financial intermediaries. They bridge the gap between knowledge of investors.

EQUILIBRIUM IN FINANCIAL MARKETS

It is assumed that perfect completion exists in the market. Equilibrium is attained by the tools of demand and supply. When there is equality between expected demand for lonable funds and supply of funds generated from savings and credit creation, market is in equilibrium. Any change in demand or supply will bring about a change in market equilibrium.

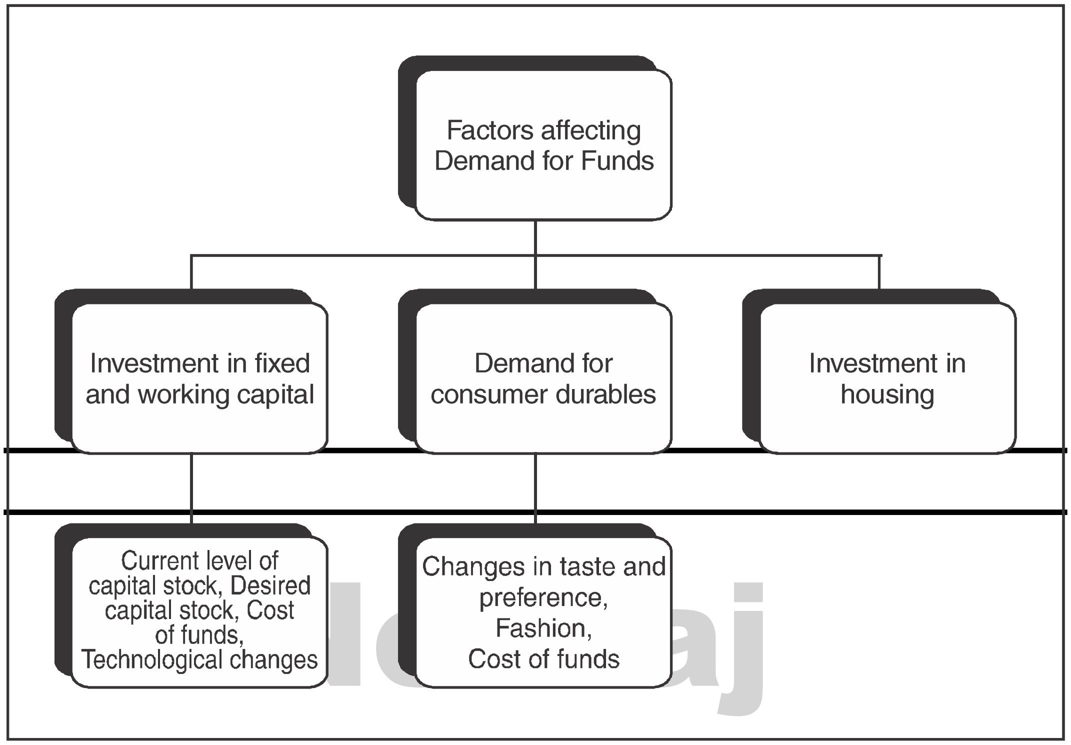
The supply of lonable funds is generated from saving of households, firms and government. Saving is the gap between disposable income and consumption.

Saving = Disposable income – Consumption

Many factors determine the volume of savings in an economy.

(i) Level of current and expected income,
(ii) Cyclical changes in income,
(iii) Distribution of income,
(iv) Rate of interest,
(v) Inflation rate,
(vi) Degree of certainty of income and wealth,
(vii) Desire to provide for old age etc.

The Demand for Funds

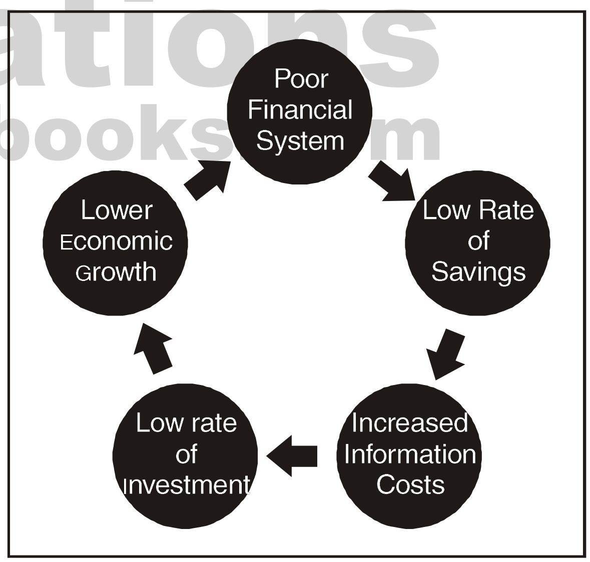


FUNCTIONS OF THE FINANCIAL SYSTEM IN THE PROCESS OF ECONOMIC DEVELOPMENT

To understand the relevance of financial system let us analyze an economic system in which there is absence of sound financial system.

Lack of Financial System and Vicious Circles

- Lack of sound financial system results into low level of investment due to lack of investment. It retards the rate of economic growth.
- In such an economy, rate of savings will be low. It will, in turn, lower the rate of investment and hence the rate of economic growth slows down further.
- When there is absence of sound financial system, the cost of information is high making investments less profitable and more risky.
- Lower savings and high information costs together aggravate the problem of low capital formation. It gives birth to a vicious circle. In such situation, economy falls into a poverty trap.



Functions of the Financial System

It is very much clear from that it is a must to have a sound financial system for a rapid economic growth. It can contribute to economic development via three routes: