Finance Fundamentals

Economics, Economy, and Finance

Capital, land, labor, and enterprise are the four things needed to start the production of any kind of goods or services. These are the four ***factors of production*** necessary to start any business. As an entrepreneur, you already have the enterprising spirit. But you need capital to avail land and labor.

Finance is an Inseparable Part of Our Lives
Image Courtesy of Freedomz at https://www.shutterstock.com/image-photo/business-financing-accounting-banking-concept-businesswoman-753656569?src=0L6fExrBf46VFu6acjUAmw-1-41

Therefore, capital is often the starting point for any business. Not just for business, we need capital for purchasing homes, cars, education, and many other things. This makes finance an inseparable part of our lives.

In the simplest of words, **finance** refers to all the monetary transactions involved for obtaining and repaying credit – credit in all forms. Although taken to mean the same as economics in the general parlance, finance is a slightly different in that it is a part of economics.

Then again there is some overlap between the terms economics and economy in the common discourse. While **economics** is a part of social sciences that studies the money-related aspects of human behavior, **economy** refers to all institutions and organizations involved with the production, distribution, exchange, and consumption of goods and services.

Credit is availed by entrepreneurs, governments, farmers, students, private citizens and the like for establishment, expansion, or diversification of business; development of physical and social infrastructure, purchase of inputs required to run an enterprise, purchase of consumer goods, education etc.

An Overview of Financial Markets

Financial Markets comprise of:

A. **Capital Market** is an institutional mechanism where medium term (usually one to five years) and long term (up to twenty-twenty five years) credit / loan transactions occur. This is not a fixed geographical location(s) but any place where the said transactions occur

   This market includes:

   - Securities Market
   - Development Finance Institutions
   - Financial Intermediaries

B. **Money Market** where loan transactions of a short term (up to one year) duration are carried out. It is made up of:

   - Organized Money Market
   - Unorganized Money Market

Capital Markets consists of:

I. Securities Markets where securities are traded viz. sold and purchased. Securities include shares, bonds, mutual fund units, derivatives, and debentures.

To raise capital, issuers sell securities. These are purchased by investors who receive returns in the form of dividend that is in terms of percentage of the value of securities purchased by them. Alternatively, investors can sell their securities in the securities market for a profit.

Securities Markets are composed of:

- **Securities Issuers**: private companies, government institutions, banks, and financial institutions
- **Intermediaries** who link the issuers with the investors such as brokers, dealers, jobbers, custodians, and merchant and investment banks

- **Investors**: individuals, mutual funds, companies, and financial institutions

- **Market Regulators**: to prevent fraud and ensure working in accordance with established regulations

Based on who issues securities, the securities market can be classified into:

- **Gilt-Edged Market** for trading of government and semi-government securities. Because the government guarantees the return on investment, such investment is regarded as extremely reliable and hence the word ‘gilt-edged’

- **Industrial Securities Market** for trading of securities of privately held companies

Again, the purpose of issuing securities can differ. Thus, we have:

- **Primary Market** where newly issued securities are traded i.e. securities of new companies as well as securities of those established companies that want to raise money for new activities such as expansion, modernization, or diversification

  Initial Public Offerings (IPO) are issued in the primary market

Price Fluctuations are a Regular Feature of Stock Markets
Image Courtesy of Phongphan at https://www.shutterstock.com/image-photo/stock-market-forex-trading-graph-candlestick-416888221?src=mvhKTBx4wCBa6LYc_TzUdQ-1-0

- **Secondary Market** for trading of securities related to established operations of existing companies

- **Derivative Market** for trading of Futures and Options in which the price for the trading deals is decided on a given day but the deals are completed at a later date. In Options, the trading parties have the option to cancel the deal after it is made

II. Development Finance Institutions (DFI) such as federal and state level development banks, investment agencies, and other organizations. Typically, DFIs:

- provide loans and advances
- purchase shares of companies
- guarantee loans obtained by creditors
- *underwrite* issue of securities i.e. guarantee the purchase of those securities that are not purchased by investors in the capital market
- provide refinance services i.e. financing those financial institutions that provide financial services to public or private establishments

III. Financial Intermediaries such as:

- **Investment Banks and Merchant Banks** that finance governments and large industrial corporations from their own funds or deposits collected from wealthy investors. They also provide other services such as:

  - *credit syndication* i.e. bringing together numerous banks to finance one single client
  - underwriting
  - *issue administration* i.e. management of issue of securities in the appropriate capital market
  - *project counseling*

  Both these kind of banks do not accept deposits from or lend money to the general public. The functions of both these type of banks are similar and in Britain they mean the same. Merchant Banks, however, are more concerned with facilitation of finance for international players

- **Mutual Funds** are deposits collected from the general public by fund managers who invest these in the capital market and provide proportional returns to the people / investors. These funds are held as a trust by the fund managers

People with little knowledge of the practical working of capital market benefit from the knowledge and experience of the fund managers. The managers profit from the fees and commissions they receive. Since both the parties benefit, they are called 'mutual' funds

Morgan Stanley is amongst the Largest Investment Banks
Image Courtesy of Ken Wolter at https://www.shutterstock.com/image-photo/los-angeles-causa-november-11-2015-339828038?src=M1S5Ym_puJRR3YUZ1BWeZQ-1-4

- **Insurance Agencies** invest their collected *premium* in the capital market. Insurance is an agreement between two parties wherein one party, the insurer, agrees to monetarily compensate accidental loss of life, limb, or property of the other party, the insured, in return for a predetermined amount paid in periodic installments (called premiums) by the insured

- **Venture Capital Funds** provide capital to those who are technically proficient but do not have access to capital

- **Credit Guarantors** are a kind of insurance service provider who cover the professional hazards for banks and entrepreneurs / creditors

- **Pension and Provident Funds** that are usually under the control of the political executive which invests these in the capital market

- **Credit Rating Agencies** that rank / rate a business enterprise on the basis of sector of economy in which the business operates and the peculiarities of that sector, profits, risks, liabilities, prospects of expansion and diversification etc.

  Such agencies also rate the economy of a country, state, or national / international region based on the investment climate, regulatory and legal framework in the economy, economic and political stability and the like

Money Market is made up of banks, Non Banking Financial Companies (NBFC), and private moneylenders.

I. Organized Money Market that is under the supervision of the central bank of the country. This sector comprises of:

- ✓ **Commercial Banks** – **Public** and **Private** that accept deposits from and lend money to general public as well as businesses

- ✓ **Cooperative Banks** are financial entities that belong to its members. The members are its customers as well as its owners

  These are special kinds of private banks in which the ownership is equally distributed among all its owners irrespective of the number of shares owned by the members. Profits, however, are distributed in accordance with the number of shares held

  Cooperatives are usually formed by people from a common locality or profession who pool their meager resources to benefit from economies of scale

- ✓ **Non Banking Financial Companies (NBFC)** are financial institutions that provide banking services despite the fact that they are registered as a company and not as a bank

  These do not comply with the legal definition of a bank but have to operate in accordance with relevant banking regulations. NBFCs cannot accept demand deposits i.e. current or saving account deposits that have to be returned on demand and cannot issue check (cheque) books to their customers

II. Unorganized Money Market that is not under the supervision, direction, or control of the central bank and includes private moneylenders and usurers

Finance: As Essential as Air & Water

Most of us regard finance as a complicated black box. But it is an essential part of our lives, one we cannot do without. Economic changes have always preceded social, cultural, and political transformations. And finance is at the center of economics!