Impact of Capital Market on the Indian Economy

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Abstract

Capital market is the place where the arrangements are made for corporate to borrow and lend medium and long term funds. It is mainly dealt with raising of money from individual savings, banks, financial institutions, government agencies and corporate savings. There has been steady increase in the investments made by the households through both the risk-free, low yielding, and fixed return financial instruments. There should be proper financial awareness and knowledge for the investors about the various investment avenues so that they don't lose their amounts by investing in bad instruments. The capital market has substantial influence on the economic development of the nation. The foreign institutional investors are the prime drivers of the financial markets in developing countries especially in India. The paper highlights the significance of capital markets, structure of the Indian capital market, role of capital market on the economy along with the role of foreign investors in the Indian capital market.

Keywords: *Financial Markets, Financial Instruments, Capital Markets, Foreign Investors, Economic Development.*

Introduction:

Human beings tend to earn, create wealth to meet one's future requirements. In the process of earning wealth, there is contribution towards the growth of the economy. There is equal importance to the earning as well as spending wisely. Appropriate financial awareness and knowledge are required while creating wealth through various financial instruments such that there is no financial turbulence to oneself as well as their family. Capital is the spearhead among the various factors of production of the economy. Capital formation is dependent on the structure of the financial system in the form of savings, investments, availability of finance etc. An individual can invest in the available financial instruments based on his earnings and subsequent savings. The returns on the individual financial instruments also influence the investment options. The financial instruments offered by the financial institutions are traded in the financial markets have interdependence among themselves which derive the fruitful result for the investor. The components of the financial system should be interlinked such that they pave the path for the economic growth of the nation.

Capital Markets:

The capital market is the place where the financial investments are made in financial instruments which result in either direct or indirect formation of the capital. The capital market include various financial institutions and operational mechanisms where the funds from investments are pooled to meet the short term, medium term and long term requirements of the governments, corporate, business firms, individuals etc. Capital market provides the venue for both the suppliers and receivers of the capital such that a balance is attained among these diverse market participants. Capital markets are the places where the outstanding securities are passed onto the investors. The investment instruments are independent of the individual savings capacity and investment time period but the returns on the investments are dependent on these factors. There are instruments where the present consumption is more in the yield bearing securities in comparison with the future consumption. The composition of savings changes when held less in the form of unused money or fruitless assets, mainly because of the availability of the diversified and liquid assets for investment for the users. Capital market is crucial in supporting economic development through technical advancements. The capital markets are liquid in nature and helps in funding the long term capital intensive projects.

The major function of the capital market is that it assists the mobilization of the savings of multiple individuals and pools into capital formation which is subsequently utilized towards the economic development of the nation. The success of the capital market depends on the utilizing of the pooled resources by the corporate sector for the economic development and at the same time protects the interest and investments of the individual investors in these corporate securities. An efficient capital market strikes the balance and the required mechanism between the capital formation for the economic activities and the protection of the investors. It may not be possible for the corporate sector to raise the capital for their business activities if the interests of the investors are not taken cared.

Capital market is defined by W.H Husband and J.C Dockerbay as "*The Capital Market is used to designate activities in long term credit, which is characterized mainly by securities of investment type*"

The major characteristics and functions of capital market include the factors like: pooling of funds towards capital formation, provision of capital for the corporate through procurement of equities, ensuring adequate liquidity to the investor while selling the assets, adoption of pricing mechanism which improves the competence of capital formation and allocation, enables the mechanism towards the valuation of the securities, channelize the available funds through investments followed by disinvestment and reinvestments, creates a mechanism for integration of financial sectors and its financial instruments through long term, medium term and short term funds, provide the effective information for the participants in the market about the avenues for investment, disinvestment and reinvestment of the funds, ensures that there is operational efficiency through simplified procedures, reduced transaction costs, reduced settlement times, and provides protection to the investors through investment protection fund along with the trading of derivatives in the market.

Objectives of the study:

- Ascertain the Significance of the Capital Markets.
- Ascertain the Structure of Indian Capital Market.
- Ascertain the role of Capital Markets on the Economy
- Ascertain the role of Foreign Investors in the Indian Capital Market.

Literature Review:

Pyare Lal Singh (1993) depicted that the persistent source of funds for the corporate is through the primary market where the household savings along with both the public and private corporate sectors. It was observed that there is an increase of 7.5 times in the investors whose number was increased from 20 lakhs to 150 lakhs in a decade time between 1980 and 1990. Similarly there is an increase in the procuring the required financing for project through securities had increased to 52.94% in 1989 in comparison to 35.01% in 1981. In this tremendous growth of the securities over the years, the share of debentures and bonds type of financial instruments had risen from 16.21% to 30.14% during the same period.

Debjit Chakraborty (1997) analysed the relationship between the stock market behaviour and the economic indicators. The paper evaluated the response of the stock market to the alterations in the economy of the country. As part of the study some of the important factors such as the inflation, progress of GDP, Cash-Deposit ratio, trade deficits, money supply and fiscal deficit are considered to evaluate the changes in the stock market index in response to the changes in these factors. BSE National Index of Equity Prices consisting of the significant 100 companies is taken as index as part of the study. It was observed that there are changes in the stock market index in respective to the changes in the money supply followed by inflation, fiscal deficit, Cash-Deposit ratio. It is also observed that the political stability has a positive impact on the market index while the political instability does negatively impact the stock market index.

Juhi Ahuja (2012) highlighted the structure Indian Capital Market. Paradigm shift was observed in Indian capital market over the years with the introduction of several reforms in the market. These changes and developments had made the Indian capital market more attractive and competent with the other capital markets across the world. Regulatory mechanism along with the implementation of modern infrastructure had resulted in improved mobilization of financial resources along with better market capitalization, and enhanced market liquidity. With the introduction of the Private Corporate Debt market had reduced the dependence on the banking sector for raising the corporate finance. The Indian capital market was subdued with the recent global financial crisis in United States sub-prime mortgage market which impacted the markets across the world.

Indian Capital Market:

The capital markets are the avenues for corporate to raise funds to meet their medium and long term financial requirements. The funds are required for both the public and private manufacturing companies, trading organisations, central and state governments to meet their financial long term as well as medium term requirements. The significance of the capital markets is self-evident particularly in the developing countries like India.

An efficient capital market is the barometer of the economic performance of any country. The developing economy like India, the financial institutions and intermediaries are vital in pooling the savings from the investors which are inturn channelized into productive investments. Investor confidence is significant for the overall development of the market as well as the economy of the country. Capital markets have a significant role in the economic development of the country along with the strengthening of the financial system. Among the emerging markets across the world, India had its own image and bright focus on it. Indian stock exchanges were in existence for over a century but their presence was felt in the late 70s and early 80s, where their role of channelizing the mobilised savings into productive investments was undertaken. Government had taken several initiatives and reforms were implemented from time to time such that the overall financial sector and capital market in particular had undergone several changes and acquired greater depth which is vital for the sustained growth of the economy. With the implementation of the economic reforms, by 90s the capital markets had witnessed considerable growth along with the identification as the important source for capital formation and mobilisation.

Some of the significant statistics of the capital markets are depicted for a period of time where it was observed that in 1972, the banking sector received banking sector received 63% while capital market received 37% of the household savings; while in 1996 the banking sector received 47% while capital market received 53% of household savings; and in 2017 the banking sector received 34% while capital market received 64% of the household savings. This indicates that there is a continuous shift of the investments from the traditional banking system to capital markets. Over the period of time along with the infusion of the household savings into the capital markets the foreign investors are also investing in the Indian capital markets thereby increasing the trade volumes in the stock exchanges. With the implementation of the advanced technologies in the operations of the capital markets, the environment had become user friendly for the investors and conducive for performing the activities which inturn helped the markets to grow interms of resource mobilizations, market capitalizations, stock exchanges which are listed for performing the activities, investor base which helped in improved volumes traded in the market.

The important components of the Indian Capital Markets are the Fund Raisers, Fund Providers, Financial Intermediaries, Organizations and Market Regulators. ***Fund Providers*** are the one who invest in Capital markets through financial instruments. Retail investors, Domestic Institutional Investors, Foreign Institutional Investors, and Foreign Investors are those who invest in the capital markets through subscription of primary issues, trading in secondary market, mutual funds, ADRs, GDRs, venture capital funds, commodities, currency trading etc. ***Fund Raisers*** are the one who are in need of funds to meet their medium and long term financial requirements. They raise the desired funds from both the domestic as well as foreign sources. The fund raisers include the public and private firms, trading organizations and also include the central and state governments. ***Organizations*** are the one where the financial activities take place. They include the primary stock exchanges like Bombay Stock Exchange, National Stock Exchange along with regional stock exchanges. Besides them there is Multiple Commodities Exchange of India Limited, two depositories namely National Securities Depository Limited and Central Securities Depository Limited. The participants in the organizations are termed as ***Intermediaries*** who act as service providers in the capital markets. Some of the intermediaries include the stock brokers, merchant bankers, sub-brokers, depository participants, venture capitalists, mutual fund agents, under-writers, transfer agents, portfolio managers, registrars, FII sub accounts, custodians etc. ***Market Regulators*** are the ones who regulate the activities undertaken in the market by the various participants and organizations. Some of the market regulators are the Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA), Reserve Bank of India (RBI), Department of Company Affairs (DCA).

Capital Market Instruments:

Capital Market comprise of Primary Capital Market and Secondary Capital Market where the financial instruments are traded. Some of the significant capital market instruments are listed below:

- Equity Shares – Rights Shares, Bonus Shares, Blue chip Shares.
- Preference Shares.
- Debentures – Convertible Debentures, Non-Convertible Debentures, Redeemable Debentures, Irredeemable Debentures, Fully Convertible Debentures, Partially Convertible Debentures.
- Bonds – Convertible Bonds, Non-Convertible Bonds, Redeemable Bonds, Irredeemable Bonds, Fully Convertible Bonds, Partially Convertible Bonds.
- Euro Convertible Bonds, Euro Equities.
- American Depository Receipt, Global Depository Receipt, European Depository Receipt, International Depository Receipt.

- Derivatives – Index Futures, Index Options, Stock Futures, Stock Options, Currency Futures, Currency Options, Commodity Futures, Commodity Options.
- Mutual Funds

Importance of Capital Markets on the Economy:

The primary function of capital market is to provide long term funds for executing the projects at competitive cost of capital. Banks also provide funds for executing the projects but for a short period of time. There are very few banks which provide credit to the corporate for long period of time. There is responsibility on part of the banks which are accountable to the creditors and the stakeholders to generate profits and this inculcates aversion towards the long term risk inherent projects. Banks normally distribute credit to the projects which are less risky, generate cash flow and deemed to be profitable. The banking industry is liable for its creditors and is normally less risk taking industry. Contrary to the banking industry, the capital markets institutions are not accountable to the creditors / investors in the case of any default. This concept of non-liability to the investors does make the capital market attractive for the fund raisers and these funds are used for long-term risk involved projects.

Some of the important influences of the capital market on the economy include:

Mobilization of Savings – with the effective capital markets environment, the scope of pooling the savings from various segments is easy. With reasonable return and liquidity of the capital market instruments enable the investor in these markets. In the absence of effective capital market system, the savings may be invested in unproductive, conspicuous consumption and wasteful instruments.

Proper channelization of Capital Formation – with the advancements in the capital formations, there is a proper system where the mobilized capital is allocated towards the institutions where the investors feel that they can derive fruitful profits in the future. The capital market is quick to respond to the fluctuations in the market to reflect the real price of the financial instruments which is beneficial for the investors as well the corporate by either encouraging or discouraging capital inflows to any organization.

Liquid and Continuous Market – the capital markets are the places where the sellers and buyers of the securities are moved to one place to perform the transactions. The holdings can be easily converted into cash as these marketable securities are more liquid when compared to other instruments.

Raising Capital – capital markets enables to raise permanent capital by the corporate. Some investors mayn’t hold the funds for such long duration so that markets enable various investors to sell and buy securities such that the company maintains permanent capital. In addition to the domestic funds, the capital markets generate funds from overseas in the form of securities, bonds etc. Along with the capital infusion by foreign investors, technology from foreign countries can be imported which is helpful for the nation’s economic development.

Revival of sick units and Backwards Areas – capital markets provide sick units with timely financial assistance to revive their operations. The funds raised through capital markets can be utilized for the long term projects to be implemented in the rural and backward areas. This helps the economic development of the rural and backward areas.

Provision of diversified services – capital markets enable the financial institutions to perform various services such as providing expertise advice, grant of loans to entrepreneurs, promotion of organizations, underwriting facilities, guidance towards participation in the equity markets, technical assistance etc. They also assist during the preparation of feasibility reports, training to the corporate, identification of growth potentials in the sector.

Promotion of reliable industrial growth – capital market assess the financial status of the corporate which promotes efficiency and encourages the investors to invest in productive industrial sector. The funds are mobilized towards corporate securities for investments. This process kindles the industry growth followed by the sector and economic development of the country.

Encouragement for investment and stability of prices – capital markets encourages investment to corporate, government organisations etc through various financial instruments by the savers. Capital formation and allocation are portable as the investment increases and reduction in the interest rates. The markets are effective in operations and nature which forces the stability of the financial instruments with the reduction in the fluctuations of the security prices. The stability to the instruments is obtained due to the provision of capital at minimum rate of interest, allocation of funds to productive projects, and reduction of speculative activities etc.

Allocation of Risk – capital markets provide returns to the investors based on their risk appetite. Higher risk instruments provide high returns and at the same time higher losses to the investor. There is a perception that the new risks are inversely correlated to the high risk instruments.

Payback to the investors – capital markets guarantees the marketability of investments, publicizes the movement of the financial instruments which enables the investors to monitor their investments and alter their investment decisions towards profitable lines, if required. The market is so equipped that the interests of the investors are safeguarded with the establishment of Stock Exchange Compensating Fund in case of any default or fraud by the institutions / companies.

Role of Foreign Investors in the Indian Capital Market:

Foreign Institutional Investor is an investor or an investment fund that does financial activities in countries other than the one in which it is registered. These are large type of investors which include Hedge Funds, Sovereign Wealth Funds, Pension Funds, Foreign Mutual Funds, Insurance Companies, University Funds, Asset Management Companies, Trusts, Mutual Funds, and Endowments etc. FIIs take financial market position in other countries capital market on behalf of native country where they are registered. There are other organisations like the banking corporations, large corporate buyers who invest in other countries capital market. FIIs are the outside companies investing in the Indian financial markets and these institutions are interested in the developing economies which provide higher rate of returns than the matured markets. These types of investors are commonly found in India and the term FIIs is popularly used in India and these institutions are permitted to participate in the market after being registered under the Securities and Exchange Board of India.

Indian economy with vigorous growth is attracting foreign investments to surmount trade deficit, current account deficit, develop infrastructure, enhance technological advancements, promote innovations, and generate employment opportunities which will promote economic development. The government had designed policies which are important for attracting the foreign investments for the development of the nation. Foreign Direct Investments are either positively or negatively affected due to the foreign investment policies, trade barriers towards the contribution of the economy and state of the GDP in the country. FDI are vital in the capital formation and inturn enhance the employment opportunities, innovations, skills, technical assistance for the company to expertise in their field. FDIs are permitted to invest in the company and control its operations and influence the business activities while the FIIs are confined to the stock exchange operations. FDI promotes the gathering of the capital along with the infusion of the required essentials for the smooth operations of the business along with the creation of employment opportunities for the skilled in the country. Foreign investments are attracted by providing concessions such that these are invested in the creation and development of infrastructure such as roads, ports, telecommunications, power etc. Some of the other areas where the foreign investments improves the economic development such as: reduction of inflation, availability of economic and social overheads, helpful in export promotion, supply of food grains, increase in employment, availability of capital goods, availability of modern technology, availability of risk capital, proper exploitation of natural resources.

Effectively managed and regulated capital markets are attractive destinations of Foreign Institutional/Portfolio Investors (FII/FPI), and these foreign investors are the biggest drivers of Indian capital market with over Rs. 12.51 trillion being invested in the market between 2002 and 2018. In the financial year 2017-18, the market capitalisation of the BSE listed companies had reached Rs. 142.25 trillion. Financial activities of FIIs are regulated by SEBI and the limitations on the investments are monitored by RBI. Foreign investors are permitted to invest in the Portfolio Investment Scheme (PIS) as part of participation in the primary and secondary capital market. There are certain regulations levied on the investments such as ceiling of investment upto 20% of the paid up capital in public sector banks and 24% in other companies. RBI is equipped with the powers to monitor the ceilings levels of FIIs investment by marking a cut-off point at 2% below the maximum permissible investment levels. Caution is flagged by the regulator to the company before accepting the final 2% of the remaining amount to be invested. There are chances for the FIIs to increase the stake above the permissible levels when the board of the investment receiving company passes a special resolution to receive the additional investments.

The recent surge in the Indian capital market is mainly due to the global liquidity, in addition to the low interest rates enabling the foreign investors to invest in fresh avenues. FIIs view Indian capital market as a good destination for their investment to earn profits due to the economic reforms undertaken by the Indian government and the tremendous capacity of the economy to grow. The investments by the foreign investors in India are consistent and expected to surge moving ahead mainly due to the demographic advantage, long term economic growth potential, increased productivity, increased competitiveness among the Indian companies etc. The appreciation of Indian currency is found attractive when compared to falling dollar value against other currencies. The Indian economy had grown by over 7.5% making some of the sectors like Banking, Telecom, Infrastructure etc more attractive for the foreign investors to invest their money which will inturn help for the economic development of the country.

Government Initiatives to promote Foreign Investments:

The investments by FPI had reached to Rs. 17,220 crores in February 2019 which is a record high for any given month. SEBI had proposed the listing of Indian companies directly in the foreign companies. SEBI had relaxed the KYC requirements for FPIs investing in the country. The prime stock exchanges, BSE and NSE, were permitted to start the commodity derivatives for trading in these exchanges. The foreign investors were permitted to invest in the commodities derivatives segment in order to hedge their exposures. NRIs were after meeting the KYC norms were permitted to invest in the commodities derivatives segment through the FPI route. The timeline was reduced from 12 days to 6 days for issuing the debt securities in the market. FPIs were permitted to invest in the Real Estate Investment Trusts and Infrastructure Investment Trust. FPIs were permitted to invest upto 25% in Alternative Investment Funds, Private Investment in Public Equity, Hedge Funds etc. FIIs were exempted from the long term capital gains on selling the securities held for more than one year.

The following are the figures of the investments received by the Indian financial markets in terms of FDI and FII.

Financial Year	GDP	FDI	FII
2006-07	4294759	34910	14660
2007-08	4987090	63800	82200
2008-09	5630060	100100	133100
2009-10	6477830	86000	137900
2010-11	7784120	42900	135300

2011-12	8736330	103167	83986
2012-13	9944010	108186	150228
2013-14	11233520	129969	30991
2014-15	12445130	191219	249853
2015-16	13682040	235782	-262
2016-17	15070244	292938	168187
2017-18	17840293	340891	172549

Source: RBI Annual Reports. Values in Rupee Crores.

Suggestions:

- Despite the advancements in the capital markets, new technologies are to be developed to capture the future financial requirements of the capital market participants.
- There is need to set certain framework for the duration of holding the investments in the capital market which brings in stability to the market.
- The confidence of the investors is to be maintained in the market for smooth conduct of the trading activities in the market.
- Development of innovative capital market instruments so as to reduce the risk for the investors and promote financing of the long term projects in infrastructure etc.
- Removing the trading barriers such that the financial institutions attain both the financial and economic liberalization.
- There should be consistent policy which ally towards the economic development of the country.

Conclusion:

The study was conducted to assess the importance of capital markets and its impact on the economic development of the country. There is a prerequisite for effective capital market is that there should be proper coordination and cooperation between the government, public organisations and private sector along with favourable political and economic conditions. The success of the capital market is dependent on the confidence of the future projects and confidence of the investor on these projects in which the funds are invested. The pivotal role is exhibited by the government in promoting confidence among the investors towards efficient capital market which boosts the economic development of the country. A well constructed capital market has strong fundamentals with lasting growth and propels the long term economic growth of the country. There is a strong belief of the Indian growth story by the foreign investors which are bringing in large foreign capital along with the technical expertise and help in developing infrastructure and promote skills and create employment opportunities. The Indian capital market is largely influenced by the foreign investments. There are instances where the FIIs follow the path traced by the domestic mutual funds and this depicts the efficiency of the market with growing presence of institutional players who are fundamentally strong.

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