

**Economic Environment and Business Strategy**  
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**Understanding the Financial Environment**

Hello and welcome to this session, which is part of the course Economic Environment and Business Strategy. In this and the upcoming sessions, we will focus on the financial environment, a crucial pillar of any modern economy and a key factor influencing our business decisions. We will begin by understanding the structure of financial markets, how they connect savers and investors, and how capital is allocated. We will explore the various types of financial instruments, including bonds, equities, and derivatives, and examine how they serve different purposes in financing, risk sharing, and investment. Next, we will examine financial intermediaries, including institutions such as commercial banks, mutual funds, and insurance companies, that play a vital role in channeling funds and managing risk within the system. In the latter part of this module, we will discuss the theories of interest rate determination and explore how credit ratings influence borrowing costs and capital access for firms and governments.

This understanding is not only essential to business strategy but also crucial for interpreting broader economic trends, policy changes, and financial stability. Let's start by understanding what the financial system does at its most fundamental level. So, the financial system serves a simple yet powerful function: it channels funds from those who have surplus savings, that is, lenders, to those who need funds to invest or spend, such as businesses, the government, households, and foreigners, so this process of fund flow can happen in two ways. One is called direct finance; in the case of direct finance, the flow is as follows: as shown at the bottom of this diagram, it occurs when lenders—those with surplus funds—lend directly to borrowers through financial markets, for example, by purchasing stocks or bonds. The channel looks like this: this is the lender side, where funds are directed to the financial market, primarily the bond market and the equity market.

Those who have surplus funds will donate them to people in need. This is the case with business firms when they issue bonds or stocks. Similarly, when the government issues bonds, households, particularly those that can buy bonds directly from corporations and governments, can also purchase these bonds. The second one, which is shown at the top, involves financial intermediaries. That is the key difference here.

Here, financial intermediaries play a crucial role. Similarly, like banks, mutual funds, and insurance companies, these entities act as financial intermediaries, serving as middlemen in this context. This is indirect finance. They collect savings from multiple lenders and channel those funds to borrowers or investors. This intermediation is especially important because it reduces risk, pools resources, and often helps to overcome issues such as asymmetric information between borrowers and lenders.

Why does this matter now? First, it promotes economic efficiency. I have written about economic efficiency here. It promotes economic efficiency by ensuring that capital flows to its most productive uses. The government can invest, and innovation can be financed. All of which contribute to greater output and economic growth.

In other words, savers—those who have surplus funds—have a surplus but are not aware of the best or most efficient utilization of their resources. So, they lend this money to those who can make the best use of it. Secondly, it improves consumer well-being. For example, consumers can borrow today to buy a house or fund education and repay the loan over time, aligning their financial flows with their life cycle needs. In short, an efficient financial system is crucial for both economic growth and personal financial planning.

Understanding how these flows operate is the first step in comprehending the broader financial landscape. Next, we proceed to our next step, where we have seen how funds flow through the financial system. Let's break it down into six key components, each playing a distinct but interconnected role. The first one is money; money is the foundation of any financial system. It serves three essential functions.

It acts as a medium of exchange. It serves as a store of value and as a unit of account. Without money, the modern economy wouldn't function. It simplifies transactions and enables us to measure and compare value across time and space. The second component is another integral part, which is financial instruments.

Financial instruments are contracts or claims that facilitate the transfer of funds from savers to borrowers, and, importantly, transfer risk to those best positioned to manage it. For example, they include deposits. I have provided a couple of examples listed below. Deposits, loans, bonds, stocks, insurance, mortgages, etc. So, think of them as tools for channeling resources and managing financial uncertainty.

Then, moving to the third component, these are called financial markets, which are the platforms, whether physical or virtual, where financial instruments are bought and sold. They facilitate price discovery, liquidity, and resource allocation. Examples include the New York Stock Exchange, the Bombay Stock Exchange, and even modern electronic trading platforms. Moving to the fourth component, these are the financial institutions.

These are the intermediaries that connect savers and borrowers, providing access to financial markets.

They also collect information about borrowers and help reduce transaction costs. For example, banks, mutual funds, insurance companies, and security firms are key entities. Moving to the fifth component, these include government regulatory agencies. One of the objectives of government regulatory agencies is not only to develop the financial system but also to regulate it, because a sound financial system is the backbone of any economy. It channels surplus funds to those who need them, enabling them to make the most efficient use of these funds. In this case, government regulatory agencies play a pivotal role.

These institutions, the government regulatory agencies, ensure that the financial system operates safely and reliably, allowing the public to utilize the economic system and channel funds to the productive sector. Keeping this in mind, government agencies and regulatory authorities establish rules, supervise participants, and determine when to intervene when market discipline fails. In India, these include the Securities and Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI), and the Reserve Bank of India. These are the key regulatory agencies in India that ensure the insurance market, the securities market, and the banking system operate efficiently while also helping them develop and grow. Then, moving to the final element, which is the central bank.

Ultimately, central banks, such as the Reserve Bank of India, play a crucial role in stabilizing the financial system. They manage the money supply, control inflation, and act as lenders of last resort during times of crisis. Together, I will give some examples here. In India, it is the Reserve Bank of India, and in the US, it is known as the Federal Reserve System, the central banking system of the United States. Together, these six components form a dynamic system that not only channels funds but also maintains stability, supports economic growth, and enables businesses and households to manage risks effectively.

Let's now move to another component, which is called the core principles of financial markets. Turning to some of the core principles of financial markets helps us understand why financial systems behave the way they do and why specific patterns, such as risk premiums or interest rates, emerge over time and across different geographical regions. So, starting with the first one, the first core principle is that Time has value, making it one of the most fundamental concepts in finance. A rupee received today is more valuable than a rupee received in the future because today's rupee can be invested to earn returns, which is why interest rates exist; they compensate for delaying consumption. You need to know that sometimes households, when they get their income, allocate it in a way that the total disposable income is divided into consumption and savings, so when the savings go to the finance market, that means they Actually, what does it mean that saving is nothing

but going with present consumption, because the ultimate objective of having income is to satisfy our wants and needs? Consumption is the present one.

Saving is, in fact, a form of postponing present consumption for the future. To do that, they need to incentivize it with a return. That's why they are getting profit or interest income. It's mainly because time has value. This is one of the fundamental principles of the financial market.

The second important principle is that risk requires compensation; therefore, investors generally dislike uncertainty. If they are going to bear risk, such as investing in a start-up or a volatile stock, they expect to be compensated for it. So, this is why higher-risk assets typically offer higher expected returns. So, the more risk you take, the more you should be rewarded. Suppose you are investing in a high-risk bond issued by a corporation; then, you can expect a higher return.

At the same time, if you are going to invest in government securities, that means you are fully assured of getting your income back; therefore, your risk is less, and you will be rewarded less. That means you will be getting a lower return. About the third principle, it is stated that information is the basis for decision-making. Information plays a key role, and SP is essential for the smooth functioning of the financial market.

Markets run on information. Investors, lenders, and borrowers all depend on timely and accurate information to make their decisions, so the more transparent and accessible the information, the more efficient and fairer the outcomes in financial markets. Then, moving to the fourth principle. The fourth principle is that markets determine prices and allocate resources. If you observe the market mechanism at work, for example, through demand and supply, it is most evident in the financial market. Unlike other markets, the financial market is where the efficient working of demand and supply is most evident.

That is the price mechanism. In a well-functioning market, prices reflect both the demand and supply of financial instruments, as well as all publicly available information. These prices help allocate resources, such as capital, to the most productive opportunities in the economy. Moving on to the next principle, stability improves welfare. Financial stability matters. When markets are stable, uncertainty is reduced, investment flows more smoothly, and consumers and businesses can plan better.

That is, consumers and businesses can plan better. That is why central banks and regulators play a crucial role, as they help ensure confidence and mitigate the risk of systemic shocks. Together, these principles form the conceptual backbone of the modern financial system and guide both market behavior and policymaking. Having said this, let us now proceed to another component: the three essential elements of the financial system. We will primarily outline the core components of the financial system here, which we will discuss in detail in this lecture and the next one.

We will begin by understanding the structure of financial markets, which involves how they are organized and the roles they play in connecting savers to borrowers. Then we will move on to the next component, which is the types of financial instruments. Various contracts and the tools used to transfer funds and manage risk, such as bonds, stocks, and derivatives, are important. And finally, we will examine the types of financial intermediaries, including institutions such as banks, insurance companies, and mutual funds that facilitate these financial transactions. Together, these elements provide the foundation for how the modern financial system functions and understanding them is essential for analyzing a strategy in any economic context.

Moving on to the first part, the structure of financial markets, we can classify them into debt and equity markets. So, debt and equity markets are here at the end of maturity. The debt market primarily comprises bonds, loans, and mortgages. This can also be classified as both short-term and long-term. There are both short-term and long-term loans and mortgages.

In between, there are also medium-term options. A key feature of the debt market is that it offers fixed returns over a defined period. For example, if you buy a bond, you will receive an annual interest rate. Similarly, if you lend money to someone, you will receive a periodic return on these loans. That means it provides fixed returns over a defined period.

Then, moving to the next one, which is called the equity market, here the return is in terms of dividends as well as changes in equity prices, which are capital gains. Equity markets are primarily markets for stocks, so they provide a stockholder—stockholder means you are a shareholder of that company—with a claim on the net income and assets of the firm in which you are invested. As you are aware, there is a higher risk; however, to compensate for this, you will generally receive a higher return when we invest in our stocks. However, you also know that the risk is sometimes very high, and you may earn very little. Sometimes you may lose your investment income itself.

So that is about the equity markets. When distinguishing between debt and equity markets, the key difference is that when you buy a bond or lend someone money, you become a debt holder, which means you have priority claims on assets and income in the event of default. Suppose we examine a firm, for example, that has issued bonds, which represent debt, and issued stocks. Suppose you bought a bond, and the other person bought a share; then you have the first claim. Claim, but you have priority claims on the assets and income in case of default. By this form, only equity holders attend, and they are residual claimants. Whatever is left over in case there is a default is there.

The first claim is for the debt holders who gave the debt loan; the second one, the

residual claimant, is mainly the equity holder. That means if you have a share in a company. You will receive only secondary preference, such as a residual claim; you are merely a residual claimant. That means the resources, including those who provided the loan and those who purchased the bonds, have a priority claim on the company's assets and income in the event of default. Let's also make a distinction between primary and secondary equity markets.

The primary market is where new securities are initially offered for sale. Typically, firms raise capital directly from investors through the primary market, which often involves underwriting by investment banks and the issuance of initial public offerings (IPOs). Once the IPOs of especially high-demand stocks are issued, you can expect them to be listed on a secondary market within a few weeks and to be traded in that market. The secondary market involves the trading of securities that have already been issued, which are those initially issued in the primary market. At that time, the firm is not engaged because the transaction is between those who want to sell the shares and those who want to buy, so it is just between the buyer and the seller; the firm will not earn anything from this transaction.

Because of its firmness, it raises capital directly through the primary market. The secondary market is for already-issued stocks and bonds. So, the BSE and NIFTY are both secondary markets. It enables investors to buy or sell existing shares. It mainly includes stock exchanges and over-the-counter markets.

Therefore, the secondary market stock exchanges are primarily facilitated by brokers and dealers. A critical question, then, is: What is the relationship between primary and secondary markets? Therefore, a well-functioning secondary market exists. This means that if securities are issued in the primary market, they can be transacted in a well-functioning secondary market. It ensures liquidity, facilitates price discovery, and fosters investor confidence, thereby encouraging participation in the primary market. That means that if the secondary market is working efficiently, then there will also be the existence of the primary market.

If there is a strong secondary market, it implies a strong primary market as well. Furthermore, firms with strong stock performance can command higher IPO prices from the primary market, helping them raise more capital directly. A vibrant secondary market supports and strengthens the efficiency and success of primary market issuance. To summarize, the debt and equity markets involve trades that include actual financial claims, such as bonds and stocks, and transactions are settled with immediate cash payments. However, in the derivative markets, trade involves contracts based on underlying assets, and instruments include futures, options, and swaps, which are primarily used for risk management or speculative purposes.

Now, let me show you a summary table comparing financial markets and instruments. So, I have summarized. This is in a tabular format. You can see the type of market. It is presented as a separate market type for the debt market, equity market, and derivative market.

I have also provided the definition here. And the key characteristics are listed here. Additionally, examples are provided for your review. This table will help you understand the financial markets and instruments more effectively. Regarding derivative markets, I have also outlined the various types of derivative markets in this section. There are three primary instruments here: one is futures, which I have defined; the settlement is presented; and the purpose is also listed.

Then, options and swaps. Then we have the money and capital markets. The money markets primarily deal in short-term debt instruments with a maturity of less than one year, whereas the capital markets focus on long-term debt and equity instruments with a maturity of more than one year. Debt securities are cash equivalents that can be exchanged for money in the case of money markets. Governments and corporations primarily use the money markets to maintain steady cash flows and for investors to generate modest profits. At the same time, the capital market refers to companies that issue stock and long-term bonds to raise money for their long-term operations.

To summarize, the financial system plays a crucial role in connecting savers and borrowers, facilitating the efficient flow of funds throughout the economy. It consists of key components, including money, markets, and instruments, as well as intermediaries, regulators, and a central bank that work together to support economic growth and financial stability. Understanding how different markets operate, including debt, equity, and derivatives, helps us appreciate the risk-return relationships and the roles they play in capital allocation and risk management. Ultimately, a well-functioning finance system promotes economic efficiency, supports investment and innovation, and improves overall welfare.

Thank you for watching this session. We will make sure that we pay attention to this content, and we look forward to seeing you in the next session. Thank you.