

**2015**

**APR-MAY**

***Aarhat Multidisciplinary  
International Education  
Research Journal (AMIERJ)***

***(Bi-Monthly)  
Peer-Reviewed Journal  
Impact factor: 0.948***

**V O L - I V   I s s u e s : I I I**

***Chief-Editor:  
Ubale Amol Baban***





## **ROLE OF CAPITAL MARKET IN INDIA**

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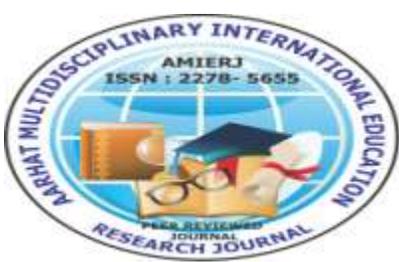
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### **Abstract**

*The economic development of any country depends on the amount of investment in a nation's output of goods and services. The financial system provides a mechanism by which savings are converted into investments. The financial system of any country consists of specialized and non specialized financial institutions of financial markets which facilitate the transfer of funds through financial instruments and services. Capital market is the market which diversifies the funds for economic development of the country. This paper describes the role of capital market in Indian economy with its historical background along with significance in pre-independence and post-independence growth. This will help the readers to know importance of capital market and understanding the historical perspective of capital market*

### **INTRODUCTION**

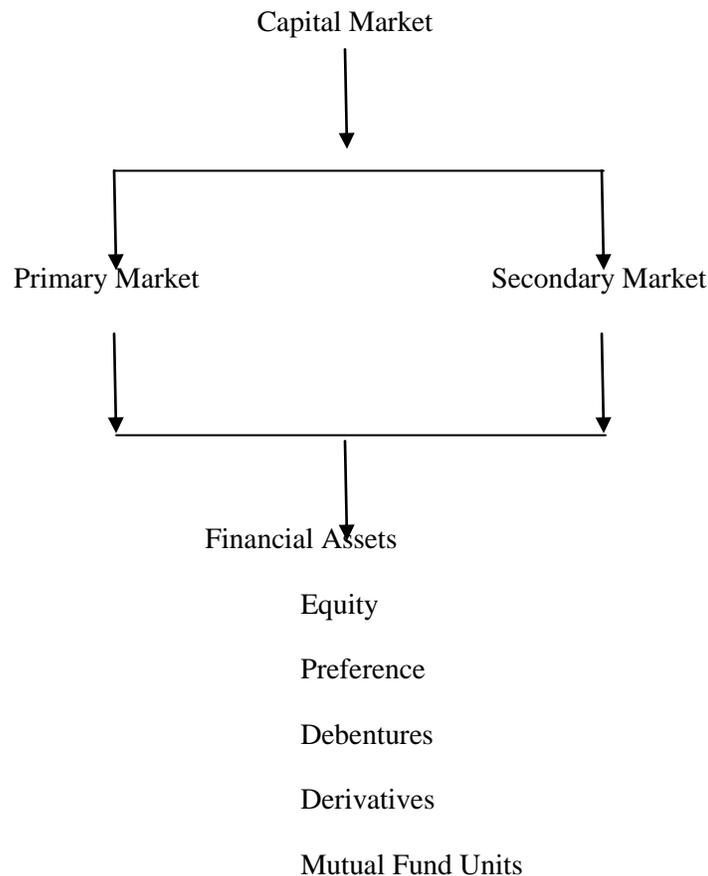
Indian Financial system plays a significant role in the development of economy. Financial system supplies the necessary financial inputs for the production of goods and services which in turn promote the well being and standard of living of the people of a country. The financial system is a broader term which brings under its fold the financial markets and the financial institutions which support the system. The major assets traded in the financial system are money and monetary assets. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Capital market is a channel through which the wealth of savers is put into long term productive use. Both the equity and bond markets are parts of Capital markets. This also includes private placement sources of debt and equity as well as organized markets like stock exchanges. Capital markets include spot and derivatives securities associated with equity, debts and exchange rates. In Indian context, the term capital market refers to only stock markets as per the common man's ideology.

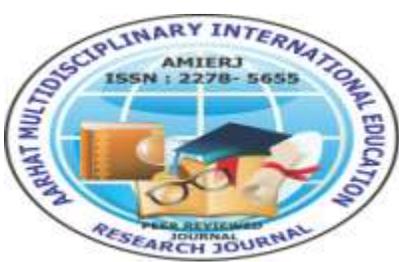


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(Bi-Monthly) Peer-Reviewed Journal Vol No IV Issues III  
APRIL-MAY 2015 ISSN 2278-5655

The capital markets such as: Government securities market, Mortgage and assets backed securities market, financial derivative market, Foreign exchange market. The main participants in the capital market are mutual funds, insurance organization, foreign institutional investors, corporates and individuals. Government and companies use capital markets to raise money for their long term investments. The capital is raised through debt and equity instruments. Capital markets are of two types: Primary Market and Secondary market. Primary Market is a market for new shares and Secondary market is a market for trading existing securities.





### **Background of Capital Markets**

The origin of capital markets goes back to the early 17<sup>th</sup> century. The Dutch were the pioneers in capital markets and they successfully leveraged the power of capital markets to withstand the British and won three wars against them, despite being a smaller nation in all aspects. Finally, British collaborated with Dutch and became an expert in leveraging capital markets that led to the rise of the British Empire one major reason for the success of British Empire over the French, despite France having population three times that of the British, was that they were able to raise capital from public at low interest rates, where as its counter parts, such as French didn't have superior financial markets and their cost of raising the capital from public was very high.

In the United states of America, the stabilization of securities market begun with the passing of the 'Blue Sky Law' in 1911 in the Kansas State to protect investors through anti-fraud provisions, regulation of brokers, dealers and registration of securities. The technology innovation in United States made them the biggest economy in the world. Information Technology led to paradigm shift and revolutionized the structure and functioning of capital markets by reducing information asymmetry and assisting faster settlements of transactions. The most significant development in capital markets in the way the technology has erased the geographical boundaries.

The story of capital markets in India dates back to the 18<sup>th</sup> Century when trading shares of East India commenced. The real story of India's capital markets started in July 1875 with the formation of stock exchange in Mumbai by the brokers. India's capital market in terms of GDP raised from 75 percent in 1995 to 130 percent of GDP in 2005. But the relative growth compared to US, Malaysia and South Korea remains low, indicating immense untapped potential.

### **Significance of Capital Market**

The capital market plays an important role immobilizing saving and channel is in them into productive investments for the development of commerce and industry. As such, the capital market helps in capital formation and economic growth of the country. The capital market acts as an important link between savers and investors. The savers are lenders of funds while investors are borrowers of funds. The savers who do not spend all their income are called. 'Surplus Units'



and the borrowers are known as 'Deficit units'. The capital market is the transmission mechanism between surplus units and deficit units.

Funds flow into the capital market from individuals and financial intermediaries which are absorbed by commerce, industry and government. It thus facilitates the movement of stream of capital to be used more productivity and profitability to increases the national income.

Surplus units buy securities with their surplus funds and deficit units sells securities to raise the funds they need. Funds flow from lenders to borrowers either directly or indirectly through financial institutions such as banks, unit trusts, mutual funds etc. The borrowers issue primary securities which are purchased by lenders either directly or indirectly through financial institutions.

The optional market prides incentives to savers in the form of interest or dividend and transfers funds to investors. Thus it leads to capital formation. In fact, the capital market provides a market mechanism for those who need funds for productive investments. It diverts resources from wasteful and unproductive channels such as gold, jewellery, real estates, conspicuous consumption etc. to productive investments.

A well-developed capital market comprising expert banking and non-banking intermediaries brings stability in the value of stocks and securities. It does so by providing capital to the needy at reasonable interest rates and helps in minimizing speculative activities.

In an underdeveloped country where capital is scare, the absence of a developed capital market is greater hindrance to capital formation and economic growth. Even though the people are poor, yet they do not have inducements to save. Other who save, they invest their savings in wasteful and unproductive channels, such as gold, jewellery, real estate, conspicuous consumption etc. Such countries can induce people to save more by establishing banking and non-banking financial institutions for the existence of a developed capital market. Such a market can go a long way in providing a link between savers and investors, thereby leading to capital formation and economic growth.

## **GROWTH OF INDIAN CAPITAL MARKET**

### **Before Independence:**

Indian capital market was hardly existent in the pre-independence times. Agriculture was



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the mainstay of economy but there was hardly any long term lending to agricultural sector. Similarly the growth of industrial securities market was very much hampered since there were very few companies and the number of securities traded in the stock exchanges was even smaller.

Indian capital market was dominated by gilt-edged market for government and semi-government securities. Individual investors were very few in numbers and that too were limited to the affluent classes in the urban and rural areas. Last but not the least, there were no specialized intermediaries and agencies to mobilize the savings of the public and channelize them to investment. Before independence, the capital market of India was ill developed. India during the British rule, exhibited most of the fundamental characteristics of an underdeveloped economy in a distinct manner. "The story of India during British rule is a story of arrested economic development". Before the arrival of British in India, the economy of India had lost momentum and was fast settling down to a semi-static equilibrium condition. Two basic characteristics were prominent in the period before British rule started in India- a high degree of income inequality and conspicuous consumption (i.e. consumption of luxury items) by the wealthy class. British were not keen in bringing out an all-round economic growth of India. Its main task was to make India complementary to Britain's own economy and the maintenance of political control. In short, India's lack of economic development must be attributed, in considerable measure, to her political subordination to Great Britain. With political subordination went economic subordination. From the beginning almost until the end of British ascendancy, India was regarded as a kind of economic complement to Britain. Accordingly, the development of an economically rounded and strong India was never a basic objective of British policy. The result was an automatic suppression of this stimulus to economic growth. A vast number of people were in a state of appalling poverty. The rate of savings in the economy was hopelessly low and the advances made in communications, trade and industry was scarcely enough to meet the pressure of population.

## **After Independence:**

In recent years since independence, the capital market of India has substantially changed and has been changing for the better. The concentrated effort on the part of the government and



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the growth of investment-mindedness of the people has made this possible. Capital market in India till the recent past had all the characteristics of an underdeveloped economy. It was characterized by the conspicuous absence of institutions like, professional promoters, investment or issue houses, underwriting agencies and financial intermediaries. As a result, free flow of savings to industrial investment was impeded resulting in the stagnant character of our economy. Thus, serious flaws existed in the structure of capital market in India. However, the achievement of independence in 1947 marked a trend towards an organized growth of capital market. After achieving political independence, government took over the responsibility of giving shape to those coveted ideals of our economy, which were enshrined in our Constitution by way of the Directive Principles of state policy. When the Constitution was framed, the government defined its basic economic and social goals that were later on summed up in the expression "socialist pattern of society". These ideals directed the government to promote the welfare of the society by securing and promoting a social order in which justice, equality and fraternity could prevail. The resolution was adopted at the Avadhi Session of Congress in 1954 to build the society on the socialistic pattern. "Ever since then this has been the light house of our economic policy", "Growth with social justice" and "Social Gain not private Profit", have been the major planks of our plan policies. These basic objectives had a significant bearing on the organization of the Capital Market. But it required effective control on government over the distribution of credit and finance and thus it could not be isolated from the strategy of economic development. In the post independence days, the government had committed itself to reorganize the Indian Capital Market. The government's commitments towards industrialization also required the removal of basic deficiencies of the capital market. The existing financial institutions could only partly meet the financial requirements of industries. Priority now shifted from private ownership to public control. The first amongst these actions was the nationalization of RBI in 1948.

Since Independence, the Indian capital market has made widespread growth in all the areas as reflected by increased volume of savings and investments. In 1951, the number of joint stock companies (which is a very important indicator of the growth of capital market) was 28500 both public limited and private limited companies with a paid up capital of ₹ 775 crore, which in 1990 stood at 50000 companies with a paid up capital of ₹ 20000 crore. The rate of growth of



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investment has been phenomenal in recent years, in keeping with the accelerated tempo of development of the Indian economy under the impetus of the five years plans.

## Conclusion

Thus it can be concluded that capital market plays a crucial role in mobilizing domestic resources and in channeling these efficiency to most productive investments. An efficient functioning of the financial system facilitates the free flow of funds to more productive activities and thus promotes investment. Capital market is the heart of any economy through which the savings are channelized into effective long-term investments. A developed and vibrant capital market will immensely contribute towards speedy economic growth and development.

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