

Explaining The Fundamentals of Financial Markets: A Theoretical Review

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Abstract

This paper attempts to explain the basic compositions of financial markets. Using a theoretical research approach, the paper highlights the definition, characteristics, types, functions, and role of financial markets in the economy of a given nation. Further, the importance of financial markets has also been underscored in this paper. Therefore, the aim of this paper is to highlight the nature, characteristics and importance of typical financial markets using a theoretical approach.

Keywords: financial markets, money markets, capital markets, stock markets, bond markets, derivative markets; forex market; capital formation

DOI: 10.7176/RJFA/13-20-08
Publication date: October 31st 2022

1.0 Introduction

The financial system is critical in any economy because it promotes economic growth and has an impact on economic performance and well-being. This is made possible by financial infrastructure, which transfers funds from companies with money to those who can put it to better use. A financial system allows for more efficient money transfers. The problem of information asymmetry and inefficient resource allocation that occurs when one party to a transaction has superior information than the other (Arnold, 2010).

By addressing the issue of information asymmetry, the financial system encourages balance between those who have money to invest and those who do not. According to the structural approach, financial markets, financial intermediaries (institutions), and regulators make up the majority of the financial system of an economy. Every component serves a certain purpose in the economy (Ainagul and Regina, 2013).

Additionally, financial markets provide the most evidence of the extent of globalisation processes when compared to other industries. The amount of global business has dramatically expanded during the last few years (Ainagul and Regina, 2013). However, in recent years, the growth of international trade has trailed behind that of the financial markets. The main competitors for the distribution and profitable use of loans during the market's development were industrial and financial businesses. The main difference in the modern era is that financial institutions have become significant drivers of the expansion of the global economy and have shifted the majority of transactions to benefit themselves. Consequently, the financial market is probably the most pervasive and enduring idea in society. The aim of this paper is to highlight the nature, characteristics, and importance of typical financial markets using a theoretical approach.

2.0 Definition and Characteristics of Financial Markets

A financial market is a place where companies and investors can raise capital to expand their operations and realize large returns on their investments. In this market, buyers find respectable vendors, and vendors get a good deal by having the greatest clients for their financial products. Financial markets include any setting where securities are traded, including stock exchanges, bond markets, foreign exchange markets, and derivatives markets (Darskuviene, 2010).

Based on a variety of variables, these marketplaces are divided into numerous groups. On the other hand, the main classifications are based on the claim type, claim maturity, delivery time, and organizational structure. A financial market, for instance, might be classified as either a debt market or an equity market depending on the kind of claim. Investors deal with shares in the latter while they swap bonds and debentures in the former (Atack and Neal, 2009).

Generally speaking, financial markets differ from other traditional markets like the commodities and real estate markets in several ways. Traditional markets enable the actual buying, selling, and providing of goods and services, as well as the giving of advantages to those who use them (Arnold, 2010). However, since transactions are conducted over computer networks, physical Sukuk or securities, to name a few, are not required in markets like those for securities.

Additionally, financial instruments like bonds and stocks are used to generate returns and profits from investments rather than being consumed in and of themselves. Financial markets have enormous daily transactions that sometimes approach billions of dollars when compared to other markets. Securities dealers are frequently required by law to buy and sell through a financial broker. However, using a broker's services is not necessary in traditional markets (Avgouleas, 2014).

3.0 Types of Financial Markets

3.1 Money Markets

The financial market's money market is a section where financial goods with high liquidity and brief maturities are traded. The money market has developed into a segment of the financial market for buying and selling assets with brief maturities of one year or less, like commercial paper and treasury bills (Spencer, 2003).

Treasury bills, commercial papers, and certificates of deposit are examples of money market products. Businesses and other players trade commercial papers on the market in order to raise finance. The money market is regarded as a secure place to invest due to the high liquidity of securities. Default on securities like commercial papers is one risk that investors need to be aware of. Various financial organisations and dealers wishing to lend or borrow securities make up the money market. The best place to invest in liquid assets is through this source (Atack and Neal, 2009).

The money market is an unregulated, unorganized market that lacks the codified framework of the capital markets. Those who invest in the money market receive a smaller return, but it does offer a variety of goods (Baker, Filbeck, and Ricciardi, 2017). Withdrawing money from the money market is now less complicated. Money markets and capital markets are distinct from one another because money markets are used for a shorter amount of time while capital markets are used for a longer amount of time.

3.2 Capital Markets

The term "capital market" is a general one that describes the physical and digital marketplaces where diverse entities trade different types of financial assets. Examples of these markets include the stock market, bond market, currency market, and foreign exchange market. Large financial centers like New York, London, Singapore, and Hong Kong are where most markets are concentrated (Ainagul and Regina, 2013).

Customers and fund suppliers both make up the capital markets. Families are suppliers through their bank savings accounts, as are organisations like pension and retirement funds, life insurance companies, charitable foundations, and non-financial industries that generate surplus funds. Among the "customers" of capital market money include people who buy houses and cars, non-financial companies, and governments that finance infrastructure investment and operating costs (Quiggin and John, 2018).

In general, capital markets are used to supply financial items like stocks and bonds. Stocks that represent ownership holdings in a company are called equities. Bonds and other debt securities are IOUs that accrue interest. Both main and secondary markets are used to exchange existing assets. Primary markets are where new equity stock and bond issues are sold to investors. A contemporary economy cannot function without capital markets because they enable the transfer of wealth from those who possess it to those who need it for economic activity (Atack and Neal, 2009).

3.3 Stock Markets

Investors buy and sell firm shares on the stock market. It is an exchange system where businesses can swap shares and other securities. It consists of over the counter (OTC) markets, where investors conduct direct securities transactions with one another (rather than through an exchange). On listed markets like the Lusaka Securities and Exchange, stocks are exchanged (Thakur and Vaidya, 2018).

An investor or trader (retail or institutional), as well as market makers and specialists who maintain liquidity and offer two-sided marketplaces, are typical participants in the stock market. Brokers are independent middlemen that help buyers and sellers' complete transactions but do not really own any stock (Quiggin and John, 2018).

3.4 Bond Markets

The primary market and secondary market are the two segments of the bond market. Due to the fact that all transactions take place between bond issuers and bond buyers, the primary market is commonly referred to as the "new issues" market. In essence, new debt instruments that have never been offered to the public are created as a result of the primary market (Thakur and Vaidya, 2018).

To raise money for a range of goals, including supporting current operations, growing product lines, and constructing new industrial facilities, businesses issue corporate bonds. Corporate bonds are often longer-term financial instruments with a minimum one-year maturity (Spencer, 2003).

Nationally issued government bonds, commonly referred to as sovereign bonds, entice investors by paying out the face amount indicated on the bond certificate at the predetermined maturity date and making periodic interest payments along the way. This feature makes government bonds appealing to cautious investors. Given that it is supported by a government that has the power to tax its people or generate money to make payments, sovereign debt is often viewed as the least risky type of bond (Avgouleas, 2014).

Municipal bonds, also referred to as "muni" securities, are issued domestically by states, cities, special-purpose districts, public utility districts, public schools, publicly owned seaports and airports and other government-owned institutions in order to raise funds for a range of activities (Ainagul and Regina, 2013).

3.5 Derivatives Market

The derivatives market is a type of financial market where securities are traded whose value is based on an underlying asset. Contracts with both two parties give rise to derivatives, which do not actually exist in the real world. Debentures, equities, currencies, and other assets could be among the underlying assets. The market value of an underlying asset determines the value of a derivative contract. Derivatives, including futures and forward contracts, swaps, options, and more are traded on this market (Avgouleas, 2014).

3.6 Forex Market

Banks and private individuals can buy, sell, or swap currencies in the forex market to achieve both hedging and speculative goals. The largest financial market in the world is the foreign exchange (forex) market, which brings together banks, businesses, central banks, hedge funds, investment management companies, forex trading dealers, and investors (Quiggin and John, 2018).

4.0 Functions of Financial Markets

4.1 Price Determination

For the numerous financial products transacted between buyers and sellers on the market, the financial market serves as a means for price determination. The prices at which investment products trade on the financial market are influenced by market dynamics including supply and demand. As a result, pricing for both new bonds, financial assets and current stocks of capital instruments is done through the financial market (Robert, Wright and Quadrini, 2012).

4.2 Funds Mobilisation

Along with choosing the prices at which financial products trade on the financial market, participants choose the required return on the investor's capital invested. The required rate of return that investors want determines the motivation of people looking for money. Only this function of the financial market can indicate how funds from lenders or investors will be distributed among individuals in need of cash or raised through the issuing of financial instruments on the market. As a result, the financial market helps to raise money from investors (Thakur and Vaidya, 2018; Mwange, 2022).

4.3 Liquidity

The liquidity function of the financial market allows investors to sell their financial instruments at the market's current fair value at any moment during the market's working hours. If the financial market lacks a liquidity function, the investor is compelled to hold the financial securities or financial instrument until conditions in the market arise to sell those assets or the issuer of the security is contractually obligated to pay for the same, for example, at the time of maturity in the case of a debt instrument or at the time of the company's liquidation in the case of an equity instrument is until the company is either voluntarily or involuntarily liquidated (Robert E. Wright and Vincenzo Quadrini, 2012). As a result, investors can easily sell their securities and convert them into cash in the financial market, providing liquidity.

Investors can sell their financial instruments at the market's current fair value at any time during market hours thanks to the liquidity function of the financial market. When a financial market lacks a liquidity function, investors are forced to hold on to their financial securities or financial instruments until either market conditions allow them to be sold or until the issuer of the security is contractually required to pay for them, such as when a debt instrument matures or when a company is involuntarily liquidated in the case of an equity instrument (Robert E. Wright and Vincenzo Quadrini, 2012). Investors can so readily sell as a result.

4.4 Risk sharing

Investors can sell their financial instruments at the market's current fair value at any time during market hours thanks to the liquidity function of the financial market. When a financial market lacks a liquidity function, investors are forced to hold on to their financial securities or financial instruments until either market conditions allow them to be sold or until the issuer of the security is contractually required to pay for them, such as when a debt instrument matures or when a company is involuntarily liquidated in the case of an equity instrument (Wright and Quadrini, 2012). Investors can so readily sell as a result.

4.5 Easy Access to Funds

Investors need to raise capital, and industries need investors to put their money into investments and generate returns. In turn, this makes it simple for buyers and sellers to find one another on the financial market platform, saving both parties money and time.

4.6 Reduction in Transaction Costs and Provision of the Information

Several different types of information are needed by the trader while buying and selling stocks. To get the same results, it costs time and money. The financial market, on the other hand, enables traders to receive all kinds of information without having to make any financial commitments. The financial market cuts transaction fees in this way (Quiggin and John, 2018).

4.7 Capital Formation

Financial markets act as a channel for foreign investors' savings to enter the nation, aiding in capital formation for organisations that, for instance, need money to start a new project but do not currently have it. Some investors, on the other hand, have additional money and want to invest it in opportunities where they can earn the requisite rate of return. The financial market therefore will function in such circumstances, enabling the company to raise money from investors and the investors to deposit their funds there (Thakur and Vaidya, 2018).

5.0 Role of Financial Markets in Economic Growth

Financial markets are designed to hasten economic growth by increasing domestic savings and investment quantity and quality. By presenting customers with a new financial product that would better suit their risk preferences, the market is anticipated to encourage savings. The need for liquidity as well as better savings mobilisation could increase the saving rate. Additionally, the financial market makes it less expensive for growing companies to raise capital. Additionally, businesses in developed stock markets rely less on bank financing, which lessens the likelihood of a financial crisis. As a result, by encouraging personal savings and providing channels for corporate investment, the financial market can positively impact economic growth (Pilbeam, 2010; Mwange, et. al., 2022)

A variety of financial instruments are available on the capital market, enabling participants in the economy to mix, value, and trade them. Through assets with alluring returns, liquidity, and risk characteristics, it encourages financial savings. This is crucial for both long-term fund suppliers and the government and other institutions that require long-term financing. Companies can raise money to run their business by issuing ownership securities like stocks or bonds. While debenture/bond issues mature over a period of years ranging from medium to long-term, typically between five and twenty-five years, stock has a continuous life (Spencer, 2003; Mwange and Meyiwa, 2022).

Additionally, the support they provide for the transmission of monetary policy, which is made feasible by liquid securities markets, is another macroeconomic benefit of well-developed capital markets. They can also serve as the "spare tyre" for the financial sector, enhancing financial stability and reducing vulnerability to exchange rate shocks and abrupt halts in capital flows. The World Bank Group's study indicates that developing countries with robust bond markets were better equipped to handle the global financial crisis of 2008, minimising substantial economic disruptions and supporting companies and individuals in retaining their financial solvency and liquidity (Atack and Neal, 2009).

6.0 The Importance of Financial Markets

The fact that financial markets act as a marketplace for the purchase and sale of financial assets is one of their key functions. Prices are determined by the forces of supply and demand in the market. Savings from investors are mobilised so they can be invested for profitable goals. Because it connects traders with potential buyers or sellers for the deal, it is one of the most sought-after platforms. Investors can sell their financial securities on the financial markets, providing tradable assets with liquidity as a result (Quiggin and John, 2018).

For numerous economic actors, financial markets offer substantial benefits. For a company or other organisation in need of money, the domestic capital markets offer an extra source of finance that can be used in addition to bank financing. Longer maturities, better pricing, and access to a bigger investor base can all be found in financial markets. Additionally, they can finance riskier ventures that are typically ignored by the banking sector, which greatly promotes economic innovation (Atack and Neal, 2009)

While some countries have access to global financial markets, the development of local financial markets can improve access to borrowing in local currencies, enabling governments to better control inflation and foreign exchange risk. The ability to finance fiscal deficits by borrowing from local markets without taking on exchange rate risk is a key advantage for governments. Government borrowing has historically been done in local currency and linked to the exchange rate on international markets, but local markets have the advantage of making it simpler to access local investors and, in some circumstances, local banks. Additionally, governments attempting to finance development internally might greatly benefit from the creation of local financial markets (Darskuviene, 2010).

Investors and savers may discover that capital markets offer more lucrative investment options than bank savings, depending on their risk tolerance, liquidity needs, and other factors. Due to the availability of a wider range of assets and instruments in the capital markets, investors can also benefit from these markets in terms of portfolio diversification and risk management (Avgouleas, 2014).

7.0 Conclusion

The market exists because of the savings that are invested on it which are expected to grow. Any country's financial market serves a variety of purposes by enabling businesses and traders to buy and sell various financial instruments and securities. By transferring money between savers and investors, it serves as a middleman between them and influences the values of assets. The key is efficient allocation of these resources and minimizing the risk through diversification of funds. It is essential for distributing the scarce resources that are available in any nation's economy and hence contributing to the growth of an economy as the critical element of any thriving economy is its financial market.

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