A STUDY OF THE MONEY MARKET IN INDIA

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Abstract

The economic growth of nation is dependent on the capital formation .The process of capital formation requires a system which will create and channelize savings. This system is called the financial system. Money market is the part of the financial system which generates liquidity in the economy. Money market is a market for short term securities where borrowers and lenders exchange short term funds to solve their liquidity needs. It is the place where short term surplus investible funds at the disposal of financial and other institution and individuals are bid by borrowers comprising institutions, individuals and government itself.

The monetary policy of the central bank has great impacts on the economy. Money market plays an important role in the monetary policy of the country. Money market through its different players ensures liquidity in the economy and has the capability to prevent the economy form the tides of trade cycles. In the present research articles the effort are made to highlight the constituents, intermediaries and instrument of money market. Researcher endeavor is also to focus the contribution of money market in the development of Indian economy.

Keywords: Money Market, Economy, Liquidity.

INTRODUCTION :

Money market basically refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded. Money market has become a component of the financial market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers certificates of deposited etc. It is used by many participants, including companies, to raise funds by selling commercial papers in the market. Money market is considered a safe place to invest due to the high liquidity of securities.

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A money market is a mechanism which makes possible for borrowers and lenders to come together. Essentially it refers to a market of short-term funds. It meets the short-term requirements of the borrowers and provides liquidity of cash to the lenders.

In the words of Crowther, " money market is the name given to the various firms and institutions that deal with various grade of money".

According to RBI, " the money market is the centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial, other institutions and individuals are bid by the borrowers again comprising institutions and individuals and also by the governments."

A well-developed money market is essential for the efficient functioning of a central bank. Money market is an institution through which surplus funds move to the deficit areas so that temporary liquidity crisis can be tackled. Money market enables inter-bank transactions of short-term funds. A well-knit money market acts as a 'barometer' for central banking operations. It enables the central bank to implement its monetary policy efficiently.

In the absence of a well-coordinated banking system and other constituents of money market, the central bank may not be able to achieve its desired goals. Above all, government deficits are financed in a non-inflationary way through the money market institutions. Thus, the existence of a well-developed money market is essential for an economy.

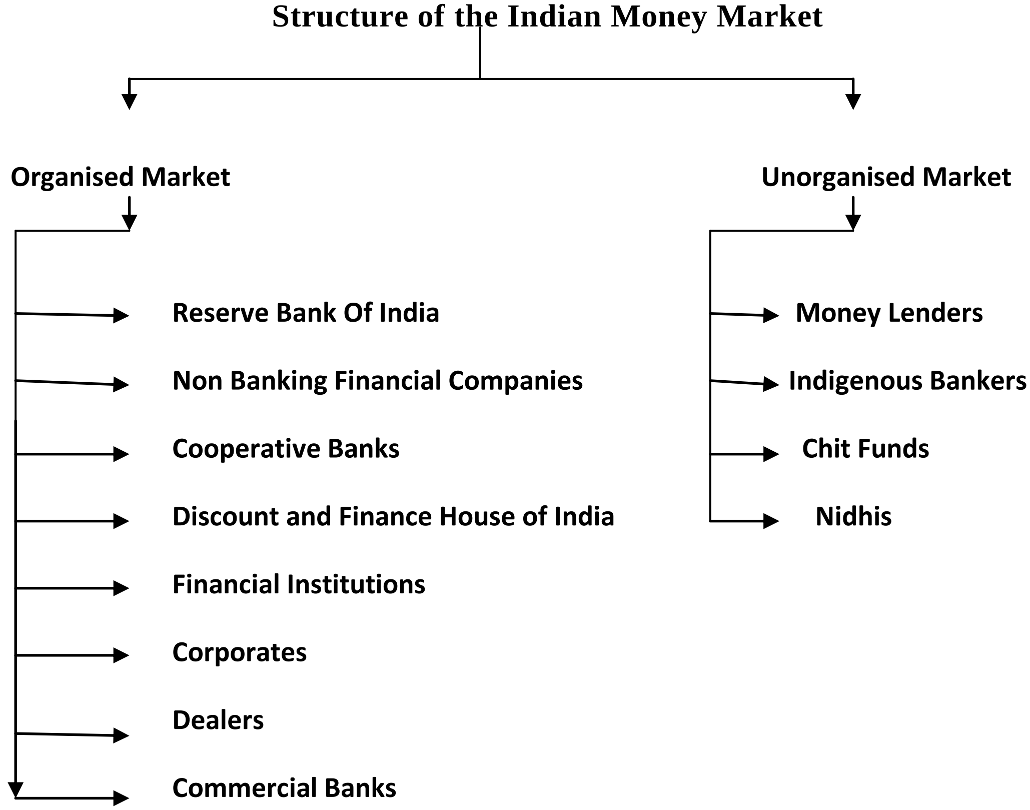
INDIAN MONEY MARKET:

The India money market is a monetary system that involves the lending and borrowing of short-term funds. Indian money market has seen exponential growth just after the globalization initiative in 1991. It has been observed that financial institutions do employ money market instruments for financing short-term monetary requirements of various sectors such as agriculture, finance and manufacturing. The performance of the Indian money market has been outstanding in the past 20 years. '

Central bank of the country - the Reserve Bank of India (RBI) has always been playing the major role in regulating and controlling the Indian money market. The intervention of RBI is varied - curbing crisis situations by reducing the cash reserve ratio (CRR) or infusing more money in the economy.

The Indian market can be classified into organized and unorganized sectors. The unorganized sector consists of money lenders, chit funds, and indigenous bankers. These people satisfy the credit requirement of a large section of the rural masses. The organized part comprises commercial banks in India both public sector and private sector banks and foreign banks. The Reserve bank of India the apex bank is the regulator of the money market in India. It regulates the flow of the credit and money in the economy. To influence the liquidity in the system the RBI intervenes in the money market from time to time either to augment or reduce the supply of credit. The open market operation of the RBI provides signals for other segments of the financial system regarding the future monetary and credit policy of the apex bank.

Structure of the Indian Money Market



MONEY MARKET INSTRUMENTS :

Money Market Instruments provide the tools by which one can operate in the money market. Money market instruments are used by corporations, governments and individual investors. Common types Of Money Market Instruments are:

Money Market Instruments

Source: Compiled by author

(1) Call Money Market:

The call /notice money is a money market instruments for trading for very short period in liquid financial assets that are readily convertible into cash at low cost. The period of lending may be for a period of 1 day which is known as call money and between 2 and 14 days is known as notice money. Term money refers to borrowing/lending of funds for a period exceeding 14 days. The interest rates depend upon surplus funds available with the lenders.

The call money market is a most common form of developed money market. It is a most sensitive segment of the financial system which reflects clearly any change in it. The call money market in India is very much centered at Mumbai, Chennai and Kolkata and out of which the Mumbai is the most important one.

Normally, scheduled commercial banks, Cooperative banks and the Discount and Finance House of India (DFHI) operate in this market and in a special situation; the LIC, UTI, the GIC, the IDBI and the NABARD are permitted to operate as lenders in this call money market.

(2) Treasury Bill Market:

Treasury bill markets are markets for treasury bills. In India such treasury bills are short term liability of the Central Government which are of 91 days, 182 days and 364 day duration. Normally, the treasury bills should be issued so as to meet temporary revenue deficit over expenditure of a Government at some point of time. But, in India, the treasury bills are, nowadays, considered as a permanent source of funds for the Central Government. In India, the RBI is the major holder of the treasury bills, which is around 90 per cent of the total.

(3) **Commercial Bill Market:**

The Commercial bill market is a kind of sub-market which normally deals with trade bills or the commercial bills. It is a kind of bill which is normally drawn by one merchant firm on the other and they arise out of commercial transactions.

The purpose for issuing a commercial bill is simply to reimburse the seller as and when the buyer delays payment. But, in India, the commercial bill market is not so developed. This is mainly due to popularity of the cash credit system in bank lending and the unwillingness on the part of large buyer to bind himself to payment schedule related to the commercial bill and also the lack of uniform approach in drawing bills.Commercial bills are an instrument of credit which is very much useful to business firms and banks.

(4) Certificate of Deposit (CD) Market:

The certificate of Deposit (CD) was introduced in India by the RBI in March 1989 with the sole objective of widening the range of money market instruments and also to attain higher flexibility in the development of short term surplus funds for the investors. Initially the CDs are issued by scheduled commercial banks in multiples of Rs 1 lakh

Maturity period of CDs issued by bank varied between 7 days and one year. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. In India, six financial institutions, viz., IDBI, ICICI, IFCI, IRBI, SIDBI and Export and Import Bank of India were permitted in 1993 to issue CDs for period varying between 1 to 3 years.

Banks normally pay high rates of interest on CDs. In 1995-96, the stringent conditions in the money market induced the bankers to mobilise a good amount of resources through CDs.

(5) Commercial Paper Market:

In India, the Commercial Paper (CP) was introduced in the money market in January 1990. A listed company having the tangible net worth of minimum Rs 4 crore in the audited balance sheet can issue CP. Again the CP can be issued in multiples of Rs 5 lakhs for a maturity period of minimum 7 days and maximum of 1 year from the date of issue.

(6) Money Market Mutual Funds:

In India, the RBI has introduced a scheme of Money Market Mutual Funds (MMMFs) in April 1992. The main objective of this scheme was to arrange an additional short term avenue for the individual investors. This scheme has failed to receive much response as the initial guidelines were not attractive. Thus, in November, 1995, the RBI introduced some relaxations in order to make the scheme more attractive and flexible.

As per the existing guidelines, the banks, public financial institutions and the private financial institutions are allowed to set up MMMFs. In the mean time, the limits of investment in individual instruments by MMMF have already been deregulated. Since April 1996, the RBI has allowed MMMFs to issue units to corporate enterprises and others at par with the mutual funds introduced earlier.

(7) Inter-Bank Participation Certificates (IBPCs):

IBPC is yet another short-term money market instrument whereby the banks can raise money/deploy short-term surplus. In the case of IBPC the borrowing bank passes/sells on the loans and credit that it has in its book, for a temporary period, to the lending bank. Only Scheduled Commercial Banks can issue IBPCs.

The various features of this instrument are given below:

a. The minimum period shall be 91 days and maximum period 180 days in the case of IBPCs on risk sharing basis and in the case of IBPCs under non-risk sharing basis the total period is limited to 90 days.

b. The maximum participation in loan/cash credit under IBPC would be 40% of the amount outstanding or the limit sanctioned whichever is lower. The participation however, should be in “standard asset” only.

c. Documents to be executed by the borrower in favour of the Issuing Bank shall provide a clause that the issuing bank shall have liberty to shift at its discretion without notice to the borrower, from time to time during the subsistence of the cash credit/loan account, a part or portion of the outstanding in the said account, to another bank/bank’s participating in the scheme.

d. Interest rates are determined between issuing bank and the participating bank.

e. The issuing bank and the participating bank have to enter into participation contracts in the format prescribed.

f. IBPCs are not transferable.

g. IBPCs cannot be redeemed before due date.

(8) Repurchase Agreements (Repos):

Repo is a money market mechanism, which enables collateralised short term borrowing and lending through sale/purchase operations in debt instruments. Unlike call deposits and T. Bills, repo is not an instrument in the market. It is a process wherein a number of instruments such as PSU Bond and other securities can be used as underlying securities to borrow and lend in the money market.

Under a repo transaction, a holder of securities sells them to an investor with an agreement to repurchase back the same securities for a same amount at a predetermined date. It is essentially a lending and borrowing transaction at an agreed rate of interest known as repo rate.

In the money market, a repo transaction is nothing but collateralised lending as the terms of the transaction are structured to compensate for the funds lent and the cost of the transaction is the repo rate. In other words, the inflow of cash from the transaction can be used to meet temporary liquidity requirement in the short term money market at comparable cost.

A reverse repo is the mirror image of a repo. REPO viewed from the angle of borrower is known as reverse repo. Thus, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repo is determined in terms of who initiated the first leg of the transaction.

When the reverse repurchase transaction matures, the counterparty returns the security to the entity concerned and receives its cash along with a profit spread. One factor which encourages an organisation to enter into reverse repo is that it earns some extra income on its otherwise idle cash.

(9) Inter corporate deposit:

Inter-company deposit is the deposit made by a company that has surplus funds, to another company for a maximum of one year. It is a source of short-term financing. This market allow the corporate with surplus funds to lends to other corporate. As the cost of funds for a corporate is much higher than that for a bank the rates in this market are higher than those in other markets .ICD are unsecured, the risk inherent is high. The tenor of ICD may range from 1 day to 1 year but the most common tenor of borrowing is for 90 days.

SIGNIFICANCE OF MONEY MARKET:

A well-developed money market is essential for a modern economy. Though, historically, money market has developed as a result of industrial and commercial progress, it also has important role to play in the process of industrialization and economic development of a country. Importance of a developed money market and its various functions are discussed below:

1. Financing Trade:

Money Market plays crucial role in financing both internal as well as international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

2. Financing Industry:

Money market contributes to the growth of industries in two ways:

(a) Money market helps the industries in securing short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.

(b) Industries generally need long-term loans, which are provided in the capital market. However, capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

3. Profitable Investment:

Money market enables the commercial banks to use their excess reserves in profitable investment. The main objective of the commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of the depositors. In the money market, the excess reserves of the commercial banks are invested in near-money assets *(e.g.* short-term bills of exchange) which are highly liquid and can be easily converted into cash. Thus, the commercial banks earn profits without losing liquidity.

4. Self-Sufficiency of Commercial Bank:

Developed money market helps the commercial banks to become self-sufficient. In the situation of emergency, when the commercial banks have scarcity of funds, they need not approach the central bank and borrow at a higher interest rate. On the other hand, they can meet their requirements by recalling their old short-run loans from the money market.

5. Help to Central Bank :

Though the central bank can function and influence the banking system in the absence of a money market, the existence of a developed money market smoothens the functioning and increases the efficiency of the central bank. Money market helps the central bank in two ways:

(a) The short-run interest rates of the money market serves as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,

(b) The sensitive and integrated money market helps the central bank to secure quick and widespread influence on the sub-markets, and thus achieve effective implementation of its policy.

REFORMS IN THE MONEY MARKET :

In recent years, serious efforts have been made by the Government and the RBI to remove the shortcomings of Indian money market. RBI, in the mean time has reduced considerably the differences between the various constituents of money market. Differences in the interest rates have also been reduced by the RBI and the monetary stringency has also been reduced by the RBI through open market operations and bill market scheme.

Even then, Indian money market is still very much dependent on the call money market which is again characterised by high volatility. In the mean time, the RBI has introduced various measures to reform the money market as per recommendations of the Sukhamoy Chakraborty Committee on the "Review of the working of the Monetary system" and the Narasimham Committee report on the working of the Financial System in India.

Following are some of the important reform measures introduced to strengthen the Indian money market:

(i) Stamp Duty Reforms :

In order to remove the major administrative constraint in the use of bill system, the Government has remitted the stamp duty in August 1989. However, the experts feel that unless the cash credit system is discouraged this government decision to remit the stump duty is not going to favour the prevailing bill system.

(ii) Deregulation of Interest Rates:

Another important step to strengthen the money market was to deregulate the money market interest rates since May, 1989. This will bring interest rate flexibility and transparency in money market transactions.

Again in November, 1991.as per the recommendations of the Narasimham Committee, the interest rates have been further deregulated and the banks and other financial institutions have been advised to determine and adopt market related rates of interest as far as practicable.

(iii) Introduction of New Instruments:

The RBI has introduced certain money market instruments for strengthening the market conditions. These instruments are—182 days treasury bills, longer maturity treasury bills, Certificates of Deposits (CDs), Commercial Paper (CP) and dated Government securities.

Discount and Finance House of India (DFHI) promoted the 182-day treasury bills systematically and these bills were the first security sold by auction for financing the fiscal deficit of the Central Government. Again, the DFHI has also developed a secondary market in these bills and they become popular with the commercial banks.

Again in 1992-93, the Government decided to introduce 364 day treasury bills and discontinued the 164-day treasury bills. The 364 day treasury bills can be held by commercial banks for meeting its statutory liquidity ratio. CDs received a considerable market during 1995-96.

(iv) DFHI:

The Discount and Finance House of India (DFHI) was set up on April 25, 1988 as a part of the reform package for strengthening money market. The main function of DFHI is to bring the entire financial system consisting of the scheduled commercial banks, co-operative banks, foreign banks and all- India financial institutions, both in the public and private sector, within the fold of the Indian money market.

This House will normally buy bills and short term papers from different banks and financial institutions in order to invest all of their idle funds for short periods. DFHI has also started to buy and sell government securities from April 1992 in limited quantity with the necessary refinance support from the RBI.

(v) Money Market Mutual Funds (MMMFs):

The Government announced the establishment of Money Market Mutual Funds (MMMFs) in April 1992 with the sole objective to bring money market instruments within the reach of individuals. The MMMFs have been set up by different scheduled commercial banks and public financial institutions.

The shares or units of MMMFs have been issued only to individuals. Thus the aforesaid measures to reform Indian money market have helped it to become more advanced, solvent and vibrant. With the introduction of new instruments, the secondary market has also developed considerably.

(vi) Repurchase of options of treasury bills to develop bill market:

RBI has introduced repurchase options of treasury bills to provide larger funds to the commercial banks. This increased the quantum of the bill market and thereby money market in india.

(vii) Entry of Foreign institutions by the Governement:

More relaxation for foreign institutions to invest foreign funds in the Indian money market. This brings in more liquidity during the peak season.

(viii) Introduction of the credit rating for commercial papers aand promissory notes:

For enhancing the credibility and business of the commercial paper and promissory notes the credit rating has been introduced. As a result of the creditworthiness of these instruments the growth of the Indian money has increased.

(ix) Liquidity adjustment facility:

Through LAF the RBI remains in the money market continuous basis through the repo transactions. LAF adjust liquidity in the market through absorption or injection of financial resources.

(x) Electronic transactions:

In order to impart transparency and efficiency in the money market transactions the electronic dealing system has been started. It covers all deals in the money market.

CONCLUSION:

Indian money market is characterized by organized and unorganized one. It is one of the emerging developed money market across the globe with the number of instruments. The prominent feature is the control of the RBI and time to time monitoring of the performance of the money market different players and the framework of the stringent norms. There is much scope for further expansion of the Indian money market under the umbrella of RBI.

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