UNIT 9 FINANCIAL MARKETS

Structure

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9.0 OBJECTIVES

After studying this unit you should be able to :

- explain the nature and functions of financial markets;
- identify the types of financial markets;
- distinguish between money market and capital market;
- explain the importance of money market;
- outline the main characteristics of a developed money market;
- explain the nature and composition of Indian money market;
- identify the deficiencies of Indian money market; and
- describe the measures adopted for strengthening the Indian money market.

9.1 INTRODUCTION

You know that most business units have to raise short-term as well as long-term funds from time to time for marketing their working capital and fixed capital requirements. This necessitates not only the ready availability of such funds but also a transmission mechanism with the help of which the providers of funds (investors-lenders) can interact with the borrowers-users (business units) and transfer the necessary funds to them as and when required. This aspect is taken care of by the financial markets which provide a place where, and/or a system through which, the transfer of funds by

investors-lenders to the business units is facilitated. In this unit, you will learn about the nature and functions of financial markets and their types; the importance, composition and characteristics of a developed money market; and the structure, constituents, and deficiencies of the Indian money market, and so also the measures adopted for strengthening it.

9.2 CONCEPT OF FINANCIAL MARKET

A financial market is a transmission mechanism between investors-lenders and borrowers-users through which transfer of funds is facilitated. It consists of individual investors, financial institutions and credit instruments like bills of exchange, promissory notes, treasury bills, shares, debentures, bonds, etc. The financial markets in essence are the credit markets that cater to the various credit needs of individuals, firms and institutions on the one hand, and help in mobilisation of savings in the economy on the other. Thus, the financial markets perform economic as well as financial functions. Their principal economic function is in the form of transfer of real economic resources from those who save a part of their earnings to those who desire to have command over real resources for investment, and their financial function lies in facilitating the transfer of funds to those who need them to implement their plans.

Briefly, the main functions of financial markets are :

1 Providing facilities for interaction between investors and borrowers;

2 Providing pricing information resulting from the interaction between buyers and sellers in the markets when they trade the financial assets;

3 Providing security or dealings in financial assets;

4 Ensuring liquidity by providing a mechanism for an investor to sell the financial assets; and

5 Ensuring low cost of transactions and ready availability of necessary information.

9.3 TYPES OF FINANCIAL MARKETS

Broadly speaking, the financial markets are classified as money market and capital market. While the money market deals with short-term credit, the capital market handles long-term credit. Let us have a brief idea about these two types of markets.

9.3.1 Money Market

Money market refers to the whole network of financial institutions dealing in short-tem funds which provide an outlet to lenders and a source of supply for such funds to borrowers. It may be noted that it does not deal in cash or money as such, but handles the near money assets (short-term credit instruments) such as the bills of exchange, promissory notes, commercial paper, treasury bills, etc. with the help of which funds are borrowed for a short period by the business units, other organisations and the government. The Reserve Bank of India describes money market as "the centre for dealings, mainly of short-term character, in monetary assets. It meets the short-term requirements of borrowers and provides liquidity or cash to them by the lenders. It is the place where short-term surplus investible funds at the disposal of the financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals, and also the government".

The demand for short-term funds comes primarily from the government, business units and individual borrowers. The government probably has become the biggest borrower everywhere, requiring short-term funds to meet its current details. The firms need them for meeting their working capital requirements. The other important borrowers include stock exchange brokers, dealers in government and other securities, merchants, farmers, etc. The banks also need such funds at times and borrow from the central bank or from each other. The supply of loanable funds comes mostly from the central bank of the country, the commercial banks and other financial institutions. The central bank is the primary source of credit to commercial banks while the commercial banks constitute the most important source of short-term credit for business houses and individual borrowers.

9.3.2 Capital Market

Capital market refers to an organisation and the mechanism through which the companies, other institutions and the government raise long term funds by issue of securities such as shares, debentures, bonds, etc. It signifies the institutional arrangement for raising long-term funds and providing facilities for marketing and trading of securities. It symbolizes a system through which the public takes up long term securities directly or through intermediaries, and thus, helps in mobilising savings of the community and make them available to business units and others for long-term use.

The demand for long-term funds is made in most countries by individuals, business corporations, public corporations, the central bank, and the state and local governments. On the supply side of the market for such funds, there are four categories of lenders in any capital market, viz., individual investors, institutional investors, banks and special industrial financing institutions known as development banks.

It may be noted that the capital market consists of primary and secondary markets. The primary market deals with new/fresh issue of securities and is, therefore, known as new issue market. The secondary market, on the other hand, provides a place for purchase and sale of existing securities and is often termed as stock market or stock exchange.

9.3.3 Distinction between Money Market and Capital Market

The capital market differs from the money market in various ways. These are summarised as follows.

1 While money market relates to short-term funds, the capital market relates to long-term funds.

2 While money market deals with securities like treasury bills, commercial paper, bills of exchange, deposit certificates etc., the capital market deals in shares, debentures, bonds and government securities.

3 While participants in money market are commercial banks, non-banking finance companies, indigenous bankers, etc., the participants in capital market are stock brokers underwriters, mutual funds, financial institutions, and individual investors.

4 While money market is regulated by the Reserve Bank of India, the capital market is regulated by the Central Government and Securities Exchange Board of India (SEBI).

5 While the main components of money market are call money market, acceptance market and bill market, the main components of capital market are primary market and secondary market.

Nonetheless, both money market and capital market play an important role in meeting the financial needs of the business and are interdependent in many ways. Most of the institutions as serve money market as well as capital market, and funds freely flow between the two markets.

We shall discuss various aspects relating to money market in the sections to follow, and take up all important issues relating to capital market operations in units 10 and 11.

Check Your Progress A

1 Define financial market.

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2 Fill in the blanks.

(a) Money market provides facilities for raising .... funds.

(b) In money market funds are borrowed against various .... instruments.

(c) New issue market is also known as .... market.

(d) Money market is regulated by ....

(e) Capital market signifies the ....arrangement for borrowing long term funds and provides facilities for marketing and trading of securities.

3 Distinguish between money market and capital market.

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9.4 SIGNIFICANCE OF MONEY MARKET

The money market is one of the most important institutions in a modern economy. The industrial growth and expansion of trade are greatly facilitated by the existence of a developed money market which, through a system of various financial instruments and collateral loans, helps the busines units in meeting their working capital requirement without any difficulty. Financing of both domestic and foreign trade is highly facilitated through the system of bills of exchange. The acceptance houses and the bill market, two major components of the money market, contribute most in this respect.

The effectiveness with which the commercial banks operate in a country depends a lot on the integration and organisation of the money market. In the absence of a call loan market, the bank will have to maintain a high cash reserve ratio in order to meet the

demands of their depositors. This may erode their capacity to lend. Similarly, without a developed bill market, the banks will lack flexibility in operating their business.

A developed money market is equally important for the smooth functioning of the central bank, particularly the implementation of its monetary policy. The prevailing short-term rates of interest serve as a good measure of monetary and banking conditions in the country and provide a valuable guide for the determination of the central banking policy. In fact, the more organised a money market is, the greater is the smoothness with which the central bank can exercise control over the banking system.

The existence of a developed money market also facilitates carrying out the public debt policy by the government more smoothly. The borrowing by the government, now-a-days, is not only a measure to meet budget deficits but is also an important instrument of fiscal management, as it can easily raise short-term funds in the market through treasury bills. In the absence of money market, the government may have to take recourse to such measures as issue of paper money or borrowing from the central bank which would invariably lead to inflationary pressure.

9.5 CHARACTERISTICS OF A DEVLEOPED MONEY MARKET

In every country of the world some type of money market exists. But, while some of these are highly developed, a good number of them are still undeveloped. USA, UK and West Germany, for example, have highly developed money markets. Not only their organisation and instruments are superior to those of the undeveloped money markets, their resources are also larger. Let us have a look at the chief characteristics of a developed money market.

Highly organised commercial banking system : The commercial banks constitute the nuclear of the whole money market. They are the main suppliers of short-term funds and serve as the necessary link between the various segments of the money market and the central bank.

Preserve of a central bank : This is another essential characteristics of organised money market. A modern central bank, by virtue of its dominant position in the banking system of a country, has become a powerful monetary and banking authority. With powerful instrument of monetary control in its arsenal, it regulates the supply of funds in the money market. It comes to the rescue of commercial banks and the money market in times of shortage of funds by rediscounting eligible securities and converting near money assets into cash, and performs a valuable service through open market operations when it absorbs surplus cash during off-seasons. But for these facilities, the money market will remain very much disorganized and chaotic. Now, almost every country has a central bank. This has improved the organisation of money market in many countries.

Continuous supply of short-term securities : Continuous and adequate supply of securities such as bills of exchange, commercial bills and treasury bills is as important as the existence of organised commercial banking for the evolution of a developed money market. In fact, the strength and the efficiency of a money market very much depends upon the quality of these short-term securities and the amount of their supply. At the same time, there should be a number of dealers who are ready to buy and sell

these securities. In fact, without their presence, there will be no life in the money market as their operations create active market of these securities.

Existence of a number of sub-markets : Another important characteristic of a developed money market is the existence of a number of sub-markets, each specializing in a particular type of short-term securities. For example, London Money Market which has, for a long time, been probably the most developed money market in the world, has the call money market, the acceptance market, the discount market, and so on. It is said that, "larger the number of sub-markets, the broader and more developed will be the structure of the money market". Moreover, the sub-markets should not be independent or isolated but should form an integrated structure in which every segment of the money market has intimate relationship with each other. This is essential to ensure uniformity of interest rates in various sub-markets and also for the free flow of funds from one sub-market to another and for the effective control of the entire money market by the central bank.

Ample supply of funds : In developed money markets there is always ample supply funds, both from domestic and foreign resources. It is observed that while developed markets like London and New York attract funds from all over the world, the undeveloped money markets face scarcity of funds as the backwardness of these markets and absence of stable exchange rates inhibit flow of funds from foreign sources.

Other factors : Apart from the above, there are many other factors such as large volume of international trade leading to a well organised system of bills of exchange, greater industrial development leading to a well established stock market, and larger demand for funds that ultimately result in greater activity in the money market and contribute to the building up a developed money market.

There are not many developed money markets in the world which have all the above mentioned characteristic features. London and New York money markets are the best example of developed money markets. Other examples of international financial centres are Paris, Zurich, Frankfurt, Amsterdam and Vienna which contain most of the characteristic features of developed money markets.

Check Your Progress B

1 How does money market facilitate the carrying out of the public debt policy by the government ?

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2 Why is the money market treated as the preserve of a central bank ?

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3 Enumerate four characteristics of a developed money market.

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9.6 INDIAN MONEY MARKET

The Indian money market is broadly divided into two parts viz., the unorganised sector and the organised sector. The unorganised sector of the money market consists of the indigenous bankers and the money lenders called mahajans, seths, shroffs, chettiars, etc. who pursue the banking business on traditional lines and their practices and operations vary from place to place. Many of the indigenous bankers combine banking business with trading and commission business, and mostly deal in hundies and promissory notes. The organised sector, on the other hand, comprises the Reserve Bank of India, the commercial banks (both nationalized and private), the foreign exchange banks and the cooperative banks. The financial institutions like LIC, GIC, UTI and mutual funds are the other institutions which operate in the organised sector. Regional rural banks, chit funds and post office savings banks also play a significant role in the semi-urban areas and small towns. However, the Reserve Bank of India is the apex organisation in the Indian money market. Since it is the leader and controller of the money market, it has great responsibility in respect of its smooth functioning. In April, 1988, it set up the Discount and Finance House of India (DFHI) to perform the function of stablising the money market in India.

9.6.1 Main Constituents

Broadly speaking, the principal constituents of Indian money market are : (1) call money market, (2) treasury bill market, (3) repo market, (4) commercial bill market, (5) certificates of deposits market, (6) commercial paper market, and (7) money market mutual funds. Let us have a brief idea about their functioning.

Call Money Market : The call money market exists in almost all developed money markets. In call money market, borrowing and lending transactions are usually carried out for one day. These are often called call loans which may or may not be renewed the next day. However, the renewals are allowed upto 14 days after which the transaction has to be reversed. The call money market is also known as inter bank call money market as the participants in the call money market are mostly banks who are able to use their temporary cash surplus or meet their temporary cash deficits by mutual transactions through this market. Of late, the financial intermediaries like LIC, GIC, UTI and NABARD have also started participating actively in the call money market. To start with, they were allowed to act as lenders but later they were also allowed to borrow.

The DFHI also joined the call money market in July 1988 and it was allowed to operate both as lender and borrower. The market practice is that borrowers / lenders inform DFHI about the funds required by them or available with them at the negotiated interest rate. After DFHI and the lender / borrower confirm the transaction, these indications are converted into firm commitments. In case of borrowing by DFHI, a call deposit receipt is issued to a lender against a cheque drawn on the Reserve Bank of India, representing the amount lent. When DFHI lends, it issues the RBI cheque representing the amount lent to the borrower against the call deposit receipt. The transaction is

reversed the next day. In case renewal is to take place, DFHI can confirm the extension of the transaction on the deposit receipt by recording the date of renewal and the rate of interest. The aggregate lending by DFHI was Rs. 4,97,957 crore in 1996-97 with an average daily lending of Rs. 1,156 crore. Thus, its emergence as a major force in call money market, contributed immensely to the development of the market smoothening of short-term liquidity imbalances.

Treasury Bill Market : In India, treasury bills are short-term liability of the Central Government as these are mostly issued by Reserve Bank of India on behalf of the Central Government for meeting its temporary deficits and financing the expenditure. As such, the RBI holds most of the treasury bills. Other holders like state governments, semi-government bodies and State Bank of India do not hold them in large quantities.

Treasury bills are usually of three months' (91-days) duration issued on tap by the RBI. The 91-days treasury bills have been of two types, ordinary and adhoc. The ordinary bills are issued by RBI to enable the government to meet its needs for supplementary short-term finance, and the adhoc bills are created in favour of RBI to replenish government's cash balances and provide the medium for employment of temporary surpluses of state governments and semi-government bodies. With effect from April 1, 1997, the adhoc treasury bills have been discontinued by converting them into special securities without any specific maturity carrying interest rate of 4.6% per annum, and introduced 14-days intermediate treasury bills to provide them with an alternate arrangement to invest their surplus funds. The RBI also introduced 14-days auction treasury bills on a weekly basis with effect from June 6, 1997 to facilitate the cash management requirements of various segments of the economy by the government and help in forming a more comprehensive yield curve. However, the auction of both of these treasury bills was discontinued from May 12, 2001. The same thing happened to 182-days auction treasury bills on a fortnightly basis re-introduced w.e.f. May 26, 1999. The 364-days treasury bills had been introduced in April, 1992. Since then these are auctioned regularly on a fortnightly basis. These treasury bills are not rediscountable with RBI. Mostly the banks UTI, LIC, etc. contribute to these bills as they constitute a safe avenue for investment. It may be noted that there is no true market for treasury bills in India as there are no further dealings in them. However, these are highly secured and liquid because there cannot be a better guarantee of repayment than the one given by the government and because the RBI is always willing to purchase or discount them.

Repo Market : Repo is a money market instrument which helps in collateralized short-term borrowing and lending through sale/purchase operations in debt instruments. Under a repo transaction, securities are sold by their holders to an investor with an agreement to repurchase them at a pre-determined rate and date. Similarly, the securities can also be purchased with an agreement to resell them at a predetermined rate and date. Such transactions are known as reverse repo transactions Repo helps to manage liquidity conditions at the short-end of the market spectrum. To start with, repos were allowed only in treasury bills. But, gradually, the RBI allowed repo transactions in all government securities and treasury bills, and so also in public sector bonds and private corporate securities to broaden the repo market.

Commercial Bills Market : Commercial bill refers to bill of exchange drawn by one merchant firm on the other when goods are sold on credit or money is lent for a short period. You know that such bills can be discounted with the bank who, in turn, can rediscount them with the RBI. The commercial bill market in India is not very active and is highly underdeveloped as compared to its counterpart in UK and USA. In 1992-

93, bills purchased and discounted accounted for a mere 8.7 per cent of the total credit of all scheduled commercial banks. In fact, over the years, the importance of bill finance in India has diminished. A large amount of bills discounted consist of bills created by the conversion of cash credit and overdraft accounts of customers of the banks. Moreover, most of the bill finance provided by the commercial banks is by way of loans against the security of bills and not by way of discount or purchase of bills. Poor development of bill market in India can be attributed to lack of uniformity in drawing of bills, absence of distinction between trade bill and finance bill, high stamp duty, popularity of cash credit and overdraft arrangement, and practice of credit sales without specified time limits. All said and done, Reserve Bank of India has all along been making sincere efforts to develop the bill market in India and popularize the use of bills. But, somehow, it has not been very successful as reflected in the amount of commercial bills rediscounted by the banks with various financial institutions.

Certificate of Deposit Market : A certificate of deposit is a certificate issued by a bank to its depositors for a term deposit. Banks issue CDs in multiples of Rs. 10 lakh for deposits with maturities varying from three months to one year. Of late, the financial institutions like LIC, IFCI, IRBI, SIDBI, and Exim Bank have also been permitted to issue CDs with a maturity period of more than one year and upto three years.

CDs are issued at a discount to face value and its rate is market determined. Banks usually pay a high interest on CDs as there is no ceiling interest rate on them. Neither loans are permitted against CDs nor they can be bought back by banks. But, they can be freely transferred by endorsement and delivery. However, the holders prefer to hold them till maturity, and so the secondary activity in CDs has been non-existent.

The RBI had introduced CDs with the objective of widening range of money market instruments and provide investors greater flexibility in the deployment of short-term surplus funds. To begin with, there was lack of interest among banks in issuing CDs. But, the stringent conditions in money market in 1995-96 and the high of rate of interest encouraged banks to mobilise resources through CDs on a large scale. As a result, the outstanding amount on CDs issued rose considerably during 1996-97 but it declined again later on as the situation eased. To bring CDs at par with other instruments, the minimum maturity period of CDs was reduced to 15 days.

Commercial Paper Market : Commercial paper is a new money market instrument introduced by the RBI in January 1990 for raising short-term funds by companies. These are unsecured promissory notes issued by companies in multiples of Rs. 5 lakh with a minimum size of Rs. 25 lakh with a maturity period ranging from three months to six months. The initial investor who could be a bank, a company, an incorporated body or an individual, would pay the discounted value of CP. Since the CP is an unsecured instrument, its interest rate is higher than that of the interbank rate or bill discount rate.

The company wanting to issue CPs have to obtain a specified rating (P_2 or A_2) from an approved agency every six months. The issuing company should be a listed company, have a current ratio 1.33 to 1, and its tangible net worth should not be less than Rs. 5 crore. It is observed that high rated corporates which can obtain funds at a cost lower than the cost of borrowing from banks are particularly interested in issuing CPs. The institutional investors also find them as an attractive outlet for their short-term surplus funds. Easy liquidity conditions in the market and low cost of CPs in relation to other money market instruments and bank finance gave fillip to the issue of CPs since the

beginning of 1993 and, in March 1993 itself, the outstanding amount of CPs was more than Rs. 2,500 crore and it rose to Rs. 8,762 crore as on December, 31, 2003. This is despite the fact that many companies have not been raising funds through CPs to the extent they are permitted because of the high credit rating requirement for the purpose and the unwillingness of banks who are the largest buyers of CPs.

Money Market Mutual Funds : Money market mutual funds enable small investors to participate in the money market. The RBI announced the guidelines for setting up of MMMFs by schedule banks and public financial institutions in April 1992 for subscription by individual investors. Initially, the scheme did not receive a favourable response as the initial guidelines were not attractive. Hence, the RBI introduced certain relaxations in November, 1995 whereby the private sector was also allowed to set up MMMFs, the ceiling of Rs. 50 crore on its size was withdrawn, and the limits on its investments in individual instrument were deregulated. In April 1996, the scheme was made more flexible by allowing investment in MMMF units by corporate and others, and reducing the minimum lock-in period from 46 days to 30 days which was reduced further to 15 days later on. The MMMFs have been brought under the jurisdiction of SEBI with effect from March 7, 2000.

9.6.2 Deficiencies

In terms of both organisation and development, the Indian money market is not comparable to any of the developed money markets of the world like those in London or New York. It cannot match the extent of resources, stability and elasticity of these developed markets and suffer from a number of deficiencies which are enumerated hereunder.

1 **Existence of unorganised money market :** The existence of an unorganised sector of money market consisting of indigenous bankers and money lenders is an important weakness of the Indian money market as the RBI has little control over their activities because they seldom use the rediscounting facility. They follow their own rules of banking and finance. Many attempts were made by the RBI to bring the indigenous bankers under the organised money market and under its own influence and control, but it made little headway. Similarly, there are a number of non-banking finance companies (NBFCs) who remain outside the organised part of the money market.

2 **Lack of integration :** As stated earlier, the Indian money market consists of organised and unorganised sectors. These are completely separate from each other, their financial operations are quite independent, and what goes in one sector has little effect on the other. Similarly, the various components of Indian money market compete with each other rather than coordinating their activities. The commercial banks, for example, compete among themselves rather than having cooperation. This is so even between Indian banks and foreign banks. As a result, there is lack of adequate integration in the money market and the monetary policy of the RBI (specially the bank rate policy) has not been sufficiently effective. Moreover, it is felt that there is hardly any all India money market in its true sense though, of late, the Mumbai Money Market has been showing a tendency to emerge as the national market.

3 **Diversity in rates of interest :** In India, the interest rates prevailing in different parts of the country are not uniform. Not only that, the borrowing rate of the government, the deposit and lending rates of commercial banks, the deposit and

lending rates of cooperative banks, the lending rate of development financial institutions differ widely. Even the rates of interest charged by banks differ depending upon the locality in which they operate, the type of security they offer and the nature of the competition they have to face. It is primarily due to lack of coordination between different banking institutions and lack of mobility of funds from one section of the money market to another. However, due to RBI's effort to introduce some rationality in the interest rate structure, there has been some improvement in recent years. But, the situation is still not comparable with that in the London Money Market where the discount rate is sufficiently effective and the market rates immediately respond to changes in the discount rate.

4 **Absence of an organised bill market :** Despite the fact that both internal and foreign bills are being purchased and discounted by the commercial banks and a New Bill Market Scheme had been introduced by RBI under which it rediscounted the genuine trade bills, the bill finance (discount market) is not popular in this country and a well organised bill market does not exist. It is primarily due to (i) lack of uniformity in drawing bills between different parts of the country, (ii) general preference for cash credit and overdrafts, and (iii) high stamp duty on usance bills, etc. Moreover, due to the presence of inter bank call money market, commercial banks never felt the need of an organised bill market.

5 **Shortage of funds :** The Indian money market suffers from shortage of funds as demand for loanable funds always exceeds their supply. The shortage becomes more pronounced in busy season. Moreover, low per capita income, the existence of black money, lack of banking habit among the people, and diversified investment opportunities have considerably reduced the supply of funds in the Indian money market.

6 **Seasonal stringency of funds :** Another striking feature of the Indian money market has been the seasonal shortage of funds during a part of the year (November to June) when farm operations and trading in agricultural products require additional finance. The banks, on other hand, have surplus of funds during off-season (July to October) which is a slack season in the country. Of course, the RBI tries to offset the variations by pumping money into the market during busy season and withdrawing the same during off-season, but the fluctuations do remain.

7 **Inadequate banking facilities :** Even after the expansion of branch banking in the post national period, the banking facilities in the country have still been inadequate. The coverage of rural sector leaves much to be desired and the money lenders continue to be the primary source of credit for Indian farmers and village artisans. This has also hampered the process of mobilisation of small savings in the country side. Lack of specialised bank to provide credit to small and tiny sectors is another problem area faced by the Indian money market.

9.6.3 Reform Measures

Looking at the deficiencies of the Indian money market, it becomes abundantly clear that it is relatively still underdeveloped. The banking facilities are inadequate and the country has failed to develop market in short-term assets. In the absence of popularity of commercial paper, commercial bills and treasury bills, an active market has not emerged. The acceptance and the bill markets have almost been non-existent. There is no denying the fact that the RBI has been constantly making efforts to remove these deficiencies and some of the shortcomings have even been overcome after

nationalisation of banks and the introduction of the new bill market scheme. But, the overall organisation of the market remained underdeveloped and a lot more needed to be taken up by the government and the RBI to improve its working. Hence, on recommendations of the Chakravarty Committee on the Review of the Monetary System and the Narasimham Committee report on the Working of the Financial System in India, a few more reform measures have been introduced in recent years to strengthen the Indian money market. These are :

1 **Deregulation of interest rates :** As part of its anti-inflationary policy, the RBI has been following a policy of strict control over interest rates in the country. All along the deposit rates and lending rates of banks, the interest rate on inter bank call money and rediscounting of commercial bills have been subject to a ceiling. However, with effect from May 1, 1989, the RBI took steps to deregulate the money market interest rates and, based on recommendation of Narasimham Committee in November 1991, the banking and financial institutions were told to follow the market related interest rates. This has proved to be a significant step towards the activation of the money market.

2 **Introduction of new money market instruments:** Traditionally, the 91-days treasury bill has been the only instrument which could be traded in the Indian money market. Over the last years, the RBI has introduced four new money market instruments viz., 182-days treasury bills, 364-days treasury bills, certificate of deposit (CDs) and commercial papers (CP). The 182-days treasury bills were the first security sold by auction for financing the fiscal deficit of the Central Government and the DFHI developed a secondary market in these bills. As a result, they became popular with the banks for effective management of short-term liquidity. In 1992-93, it was decided to introduce 364-days treasury bills which, like 182 days treasury bills, could be held by commercial banks for meeting their statutory liquidity ratio. The fortnightly offerings of these bills bring in Rs. 20,000 crore per annum. CDs are another new instrument which gained a considerable market in 1996-97 but, due to improvement in the liquidity position later on, the outstanding amount of CDs steadily declined. However, since the last quarter of 2004-05, the issue of CDs by banks has started picking up. CPs as money market instrument is now more than ten year old. However, the market for CPs is driven by the demand for CPs by commercial banks which is determined by liquidity conditions in the market.

3 **Repos and reserve repos :** Another important development has been the introduction of repurchase auctions (repos) since December 1992 in government dated securities. Repos are a regular feature of RBI's market operations. The RBI has also important 'reverse repos' i.e., to sell dated government securities through auction at fixed cut-off rate so as to enable the banks to park their surplus funds. It has been using repos and reverse repos is a policy to influence the volume of liquidity in the money market and, through it, stablise the call rates. This policy is called Liquidity Adjustment Facility (LAF) and is regarded as a major instrument of monetary policy these days.

4 **Introduction of money market mutual funds :** Money market mutual funds introduced in April 1991 provide additional short-term avenue to investors. The portfolio of MMMFs consists of short-term money market instruments which also include the rated corporate bonds and debentures with residual maturity of upto one year. Currently there are three MMMFs in operation.

5 **Setting up of DFHI :** DFHI was set up with the major objective of bringing into the fold of the Indian money market the entire financial system comprising all banks and financial institutions so that their short-term surpluses and deficits are equilibrated at market related rates. It operated both as a lender and a borrower in the call money market. With its participation there has been a significance increase in the turnover of the Indian money market.

All said and done, it is observed that the statutory pre-emptions on inter-bank liabilities, the cash credit system of financing, the regulated interest rate structure the high degree of volatility in the call money rates, the availability of sector specific refinance, the scarcity of money market instruments of varying maturities and the inadequate asset liability management discipline among banks have been the major factors that inhibited the development of Indian money market. Since most constraints have been gradually removed by the RBI in recent years there is some activity in the money market. However, the volume of operations still remains rather small and a lot more remains to be done which may include steps like regulation of indigenous bankers, standardisation of hundies, establishment of acceptance houses and discount houses, development of a system of agriculture bills against standing crops, and expansion of rediscounting facilities.

Check Your Progress C

1 Distinguish between organised and unorganised money markets.

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2 Enumerate four factors to which poor development of bill market in India can be attributed to.

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3 State whether the following statements are **True** or **False.**

(a) India has a highly developed money market at the national level.

(b) Treasury bills in India are of 91-days and 364-days duration.

(c) Repo transaction refers to the purchase of securities with an agreement to resell them at a predetermined rate and date.

(d) In Indian call money market money is borrowed for one day which can be renewed from day to day upto a maximum of 14 days.

(e) Commercial bill market in India is inactive and highly underdeveloped.

(f) Certificate of deposit refers to a term deposit receipt issued by the bank to its depositors.

9.7 LET US SUM UP

A financial market refers to a mechanism through which transfer of funds from investors-lenders to borrowers-users is facilitated. Financial markets are broadly divided into money market and capital market. While the money market deals with short-term credit, the capital market handles long-term funds.

Money market refers to the network of institutions dealing in near money assets (short-term credit instruments) such as bills of exchange, treasury bills, deposit certificates, etc. with the help of which funds are borrowed for a short period by the business units, other organisations, and the government. The supply of short term funds comes mostly from the central bank, commercial banks and other financial institutions.

A developed money market helps the business in meeting the working capital requirement and financing of both domestic and foreign trade through the system of bills of exchange which facilitates the expansion of trade and industrial growth of a country. It is equally important for smooth functioning of the central bank particularly in implementation of its monetary and public debt policies and exercising control over the banking system in a country.

The chief characteristics of a developed money market are : (1) Commercial banks constitute the nuclear of the whole money market; (2) It is the preserve of a central bank which regulates the supply of funds in the money market through open market operations and, in times of shortage of funds, provide the rediscounting facility; (3) Continuous and adequate supply of short-term credit securities ensures its strength and efficiency; (4) It is composed of several sub-markets such as call money market acceptance market and bill market; and (5) There is always ample supply of funds, both from domestic and foreign sources.

The Indian money market is broadly divided into the unorganised sector and the organised sector. While the unorganised sector consists of the indigenous bankers and the traditional money lenders, the organised sector comprises the Reserve.Bank of India (RBI), the commercial banks and the other financial institutions like LIC, GIC UTI, etc. The RBI is the apex organisation in the Indian money market, and has major responsibility for its smooth functioning.

The main constituents of the Indian money market are : (1) Call Money Market which deals with extremely short period loans (called call loans) and has commercial banks as the major participants; (2) Treasury Bills Market which helps in meeting the temporary deficits of the Central Government by auction of 91-days bills by RBI; (3) Repo market which helps in collateralised short-term borrowing and lending through sale/purchase operations in debt instruments; (4) Commercial Bills Market which provides facility for discounting and rediscounting in bills of exchange drawn by one business firm on the other. Somehow, this market is not very active in India; (5) Certificate of deposit market which deals with CDs issued at a discount by banks in multiples of Rs. 10 lakh with maturities varying from 15 days to 12 months; (6) Commercial Paper Market which deals with unsecured promissory notes issued by companies in multiples of Rs.5 lakh with a minimum of Rs. 25 lakh having a maturity period ranging from 3 months to 6 months; and (7) Money Market Mutual Funds which enable small investors to participate in the money market.

In terms of both organisation and development the Indian money market is not comparable with any of the developed money markets of the world like those in

London or New York. The major deficiencies of the money market in India are : (1) existence of unorganised money market, (2) lack of integration in the unorganised and organised sectors of the market and so also among the various components thereof, (3) diversity in rates of interest prevailing in different parts of the country, (4) absence of organised bill market, (5) shortage of funds, (6) seasonal stringency of funds, and inadequate banking facilities.

Keeping in view the various deficiencies of Indian money market, the RBI has been constantly making efforts to overcome the shortcomings, but a lot more was needed to be done for the improvement of its working. Hence, on recommendations of the Chakarvarty Committee and the Narasimham Committee, a few more reform measures have been introduced in recent years to strengthen the market. These are : (1) deregulation of money market interest rates; (2) introduction of new money market instruments such as 364-days treasury bills, certificates of deposit, and commercial paper; (3) introduction of repos and reverse repos; (4) introduction of money market mutual funds; and (5) setting up of Discount and Finance House of India (DFHI) to operate as a regular lender and borrower in the call money market. However, the volume of operation in the Indian money market still remains rather small and a lot more remains to be done which may include steps like regulation of indigenous bankers, establishment of acceptance houses and discount houses, expansion of rediscounting facilities, etc.

9.8 KEY WORDS

Acceptance Market : Market where bills of exchange are accepted by renowned firms, known as acceptance houses, on behalf of its customers to enable them raise short-term funds by getting them discounted in bill market.

Call Money : These are inter bank call loans taken for extremely short period (24 hours) which can be renewed from day to day upto the maximum of 14 days after which the transaction has to be reversed.

Certificate of Deposit : A certificate issued at a discount by bank for a short-term deposit in multiples of Rs. 10 lakh, and which is freely transferable by endorsement and delivery.

Commercial Bill : A bill of exchange drawn by one business firm on the other when goods are sold on credit or money is lent for a short period.

Commercial Paper : An unsecured promissory note issued by companies with a maturity period of 3 to 6 months for raising short-term funds.

Indigenous Bankers : Firms providing short-term loans by drawing hundies and bills of exchange on the borrowers.

Liquidity Adjustment Facility (LAF): Repos policy adopted by RBI to influence the volume of liquidity in the money market and, through it, stablise the call rates.

Money Market Mutual Funds : Mutual funds established by banks and other financial institutions for subscription by individual investors for investment in money market.

Near Money Assets : Short-term credit instruments such as bills of exchange, promissory notes, commercial paper, treasury bills, etc.

Repo : A window which enables a bank or a financial institution to borrow money for a short period by selling dated government securities through auction with an agreement to repurchase them at a predetermined date and rate.

Reverse Repo : Lending by purchase of dated government securities through auction at a fixed cut-off rate by a bank or financial institution with an agreement to resell them at a predetermined rate and date.

Treasury Bills : Bills issued by RBI on behalf of the Central Government for meeting its temporary needs for supplementary short-term finance.

9.9 ANSWERS TO CHECK YOUR PROGRESS

A 2 (a) short-term (b) credit (c) primary (d) Reserve Bank of India (e) institutional

C 3 (a) False (b) True (c) False (d) True (e) True (f) False

9.10 TERMINAL QUESTIONS

1 What do you mean by money market ? Explain its importance for a modern economy.
2 Outline the characteristic features of a developed money market.
3 Discuss the main constituents of the Indian money market.
4 Distinguish between
   (a) Repo and Reverse Repo
   (b) Commercial Bill and Treasury Bill
5 Explain the deficiencies of the Indian money market.
6 What are the various measures introduced during recent years to strengthen the Indian money market
7 Write short notes on :
   (a) Call Money Market
   (b) Certificate of Deposits Market
   (c) Money Market Mutual Funds
   (d) Discount and Finance House of India.

Note : These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the university for assessment