# UNIT 9 INDIAN MONEY MARKET

## Structure



## 9.0 OBJECTIVES

After reading this unit, you should be able to:
- define money market
- distinguish between money market and capital market
- explain the role and significance of money market in a modem economy
- identify components of Indian money market
- identify drawbacks of Indian money market which make it an underdeveloped money market
- list the steps initiated by the RBI to remove defects of Indian money market.

## 9 3 INTRODUCTION

Financial markets and institutions have acquired great importance in the modem economies as finance has becqme an integral part of modern business and an essential component of economic development. Financial markets deal in financial assets and credit instruments of various kinds such as currency, deposits, cheques, bills and bonds, etc. Financial markets, in essence, are the credit markets. They cater to the various credit needs of the individuals, firms and institutions on the one hand, and help in mobilisation of savings in the economy on the other.

The structure of financial markets can be studied from three angles: 1) functional, 2) institutional; and 3) sectoral. The functional classification is based on the term of credit (i.e., short-term or long-term credit), the institutional classification is based on the nature of organisation (i.e., organised or unorganised credit market) and the sectoral classification is based on the credit arrangements for various sectors like agriculture, trade, industry, etc.

Based on the functional classification of the financial markets, we thus have the **money market** dealing in short-term credit and the **capital market** handling long-term credit. In this unit you will study the nature, structure, and drawbacks of the money market in India. You will also study the steps taken by the government to improve it.

## 9.2 WHAT IS MONEY MARKET?

**Money market refers to the whole network of financial institutions dealing in short-term funds which provides an outlet to lenders and a source of supply of fund$ to borrowers.** The short period varies from a day to a few months. **Funds borrowed against different types of credit instruments such as bills of exchange, short-term securities, promissory notes and treasury bills drawn for a short period, etc., are called near**

**money.** Thus, the term money market may sound misleading as it does not deal in cash or money but in near money assets.

Elaborating on the essential meaning of money market, the RBI 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 financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the Government.*'

Demand for short-term funds comes from Government, business concerns and private individuals. The Government probably the biggest borrower everywhere, requires short-term funds to meet current deficits. Firms need funds for working capital requirements and also to carry additional stocks. Other important borrowers include stock exchange brokers,, manufacturers, merchants, etc. The supply of loanable funds comes mostly from the central bank of the country, commercial banks and other financial institutions.

The money market may be distinguished from capital market. The capital market is concerned with the supply of and demand for long-term investible funds, whereas the money market is essentially concerned with only short-term funds. The capital market deals in bonds, stocks and shares of corporate sector and mortgage credit for long period, while money market deals with short-term needs such as working capital requirements of business concerns, individual borrowings and short-term government obligations. However, these two markets are closely related with certain amount of overlapping as the same institutions, many a time, deal in both types of loan.

Check **Your** Progress **A**

1) Fill in the blanks:
   i) Money market provides .............. term funds.
   ii) In money market, funds are borrowed against various ............... .
   iii) Distinction between money market and capital market is based on .............. classification.
2) State whether the following statements are True or False.
   i) Money market deals in money.
   ii) Capital market is a part of money market.
   iii) Capital market and money market are closely related to each other.
   iv) Financial market and credit market are essentially the same.

## 9.3 STRUCTURE OF THE INDIAN MONEY MARKET

The Indian money market is divided into three distinct parts: 1) organised sector, 2) unorganised sector, and 3) cooperative sector. However, technically the cooperative sector may be considered as a part of the organised sector.

1) **Organised** Sector: This sector consists of the Reserve Bank of India, State Bank of India and its subsidiaries, foreign exchange banks, nationalised banks, all scheduled and lion-scheduled commercial banks and the regional rural banks. Besides, some non-banking companies and financial institutions like the Life Insurance Corporation of India, the General Insurance Company of India, the Unit Trust of India, etc., also operate in the organised money market. Chit funds and post-office savings banks also play a significant tole specially in semi-urban areas and small towns.

2) **Unorganised** Sector: This part of the money market consists of indigenous bankers and the money-lenders called mahajans, seths, shroffs, chettiars, etc., in different parts of the country. Many of the indigenous bankers combine banking business with trading and commission business, whereas others deal primarily in banking activities. The indigenous bankers deal in 'hundis' and 'promissory notes'. Nearly fifty per cent of the internal trade depends on finance from the unorganised sector.

3) Cooperative Sector: The cooperative sector occupies a somewhat intermediary position between the organised and the unorganised parts of the money market. This sector primarily comprises cooperative banks, rural banks and cooperative credit **societies.** Their main purpose is to supplement the indigenous sources of rural credit.

They finance farmers, weavers, rural artisans, etc., in their production and marketing activities.

The money market is composed of many financial agencies that deal with different types of short-term credit even in the organised sector. We may discuss the following important components of money market.

1) **Call Money Market:** It is an integral part of developed money market which provides credit facility for a very short duration, not exceeding seven days in any case. It is the most active and sensitive part of the organised segment of the money market. Bill brokers and stock-brokers usually borrow call loans from commercial banks against which no collaterai security is demanded. However, in India inter-bank call money is very common. Apart from the scheduled and non-scheduled commercial banks, foreign banks and cooperative banks, other financial intermediaries like the LIC, the GIC, and the UTI have also started actively participating in the call money market.

2) **Bill Market:** The bill market or the discount market as it is called in London, is a sub-market in which short-tenn bills are bought and sold. The most important types of bills are treasury bills, bank bills and trade bills which are usually drawn for a period of 91 days. As these bills are basically post-dated cheques, they are easily discounted in the money market. In India, there is no well developed bill market, though major banks discount bills of established customers.

3) **Acceptance Market:** It refers to the market for bankers' acceptance involved in trade, both internal as well as foreign trade. Acceptance houses, in whom both the importers and exporters have full confidence, act as agents. They get commission from both the exporters and importers for this service. The acceptance market helps international trade by providing guarantee for payment on time and thereby reduce the risk involved in foreign trade. The bill is drawn on behalf of the acceptance house and not on the importer so that the bill is easily discounted at a relatively lower rate of interest.

4) **Collateral Loan Market:** When loans are offered against collateral securities like stocks, bonds, merchandise, etc., the loans are called **collateral loans.** The chief lenders in the money market are commercial banks. The borrowers take collaterals in the form of overdrafts and cash credits.

It should be noted that the different sub-markets, as discussed above, can be combined into one market. For example, call loans are taken by those who deal in discount market and many of them who discount bills also act as acceptance houses. On top of them all is the central bank of the country which is an apex body central bank is an accepted leader of the money market which controls and guides the entire activity of the money market.

## 9.4 CHARACTERISTICS OF INDIAN MONEY MARKET

### 9.4.1 Features of a Developed Money Market

A money market is considered 'developed' if it satisfies the following conditions:

1) Highly organised commercial banking system.
2) Presence of an efficient central bank.
3) Continuous supply of negotiable securities such as bills of exchange, treasury bills, short-term Government bonds, etc.
4) Existence of a number of sub-markets, each specialising in a particular type of short-term asset. The larger the number of sub-markets, the broader and more developed will be the structure of the money market.
5) Moreover, the sub-markets should form an integrated structure in which every segment of the money market is in 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.

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

### 9.4.2 Nature of Indian Money Market

Indian money market is not a very well organised and truly coordinated entity so as to be placed in the category of highly developed money market. In fact, it is composed of two categories of financial agencies: 1) organised, and 2) unorganised segments. The organised sector contains well-established, scientifically-managed financial institutions, whereas unorganised sector comprises agencies which have diversified policies. without uniformity and consistency in the lending business. In between these two segments lie post-office savings banks and the cooperative banks.

1) Organised Segment: At the apex level there is RBI, which is leader of the money market and controls the banking sector. Besides, there are joint stock commercial banks which are of two types: (i) scheduled banks and (ii) non-scheduled banks. Since July 1969, all major banks in India have been nationalised. Besides, State Bank of India and its subsidiaries are also owned by the Central Government. The public sector banks control nearly 90% of the finances of organised banking system. There are fifteen foreign exchange banks as well. Besides, the post office savings banks, cooperative banks, rural banks and chit funds also play a significant role by mobilising savings and catering to the needs of small holders particularly in semi-urban and rural areas.

2) **Unorganised** Segment: It comprises of indigenous bankers and money-lenders including unregistered chit fund companies. In India there are more than 2,500 indigenous bankers who provide nearly 50% of the rural finance. The financial activities of indigenous bankers and money-lenders are mostly confined to small towns and rural areas which lack modem banking facilities. They operate in a limited way in big cities also. They basically cater to the needs of local demand for funds and grant loans to those who are personally known to them, normally against collateral securities to minimise risk.

Hence, it is evident that Indian money market is neither a well organised nor a coordinated and homogeneous entity. Some of the major features of Indian money market can be listed as under:

1) Duality: The Indian money market is composed of two segments, viz., the organised and unorganised sectors. The former consists of modem, well organised and scientifically operating financial institutions like the RBI, scheduled and non-scheduled banks in the private and public sectors, foreign banks, post office saving banks and the cooperative banks falling somewhat between organised and unorganised sectors of the money market. The unorganised sector consists of widely scattered indigenous bankers, money-lenders, chit funds, etc., which lack scientific organisation.

2) Predominance of Government and Semi-Government Securities: The bill market, an important and the most sensitive constituent of the organised money market, is also underdeveloped in India. As compared to advanced countries, there is great paucity of good commercial bills in the country. Hence, the lion's share of the securities bought and sold are government and semi-government securities.

3) Absence of Discount Houses: There is almost complete absence of acceptance business and discount houses in the Indian money market. This is due to the fact that there is no market for commercial bills. Traders in India resort to hundis rather than scientifically drawn bills of exchange.

4) Seasonal Stringency of Funds and Fluctuations in Interest Rates: Indian economy, being essentially agricultural in nature, has its bearing on activities of the Indian money market. Considering the demand for funds, there are busy and slack seasons in India. The busy season coincides with production and marketing activities of agricultural produce. This requires additional funds during October/November to April/May which creates monetary stringency, and results in higher interest rate during the busy season and lower interest rates in slack season.

5) **Limited Scope of Banking Facilities:** Before nationalisation of 14 major banks in India in 1969, there was one branch for about 65,000 persons with majority of banks

being in big cities only. There were practically no banks in villages and small towns. Situation has improved a lot due to expansion of branches during the last 20 years. Some banking facilities have no doubt reached rural areas and small towns, but these are inadequate.

6) Isolation from International Money Markets: The Indian money market has reniaincd more or less isolated from foreign markets. There is hardly any movement of funds between the Indian money market and the foreign markets. This is partly due to exchange control restrictions on capital movements and partly due to underdeveloped nature of the Indian money market.

**Check** Your Progress **B**

1) State whether the following statements are True or False.
   i) The Indian money market is a well-organised market.
   ii) All non-banking companies are a part of the unorganised sector of Indian money market.
   iii) The short-tern1 bills are basically post-dated cheques and, therefore, easily discountable.
   iv) Acceptance houses act as agents in which either importer or exporter has full confidence.
   v) The Indian money market is more or less isolated from foreign markets.

2) Which of the following are the major features of Indian money market?
   i) Predominance of government and semi-government securities.
   ii) Highly organised commercial banking system.
   iii) Existence of a number of sub-markets, each dealing in a particular type of short-term assets.
   iv) Existence of duality.

## 9.5 PROBLEMS OF INDIAN MONEY MARKET

### 9.5.1 Nature of Problems

In terms of both organisation and development, Indian money market is not comparable to any of the developed money markets of the world like the London or the New York money markets. It also cannot match tlie extent of resources, stability and elasticity of these developed money markets. It also suffers from a number of drawbacks, of which the following are more prominent:

1) Lack of Integration: The organised and tlie unorganised sectors of Indian money market are completely separate from each other in their financial activities. There is more of competition than cooperation and coordination among various constituents of the Indian money market. The banks compete among themselves rather than having a healthy cooperation. The RBI has no effective control on the indigenous bankers as they seldom use rediscounting facilities offered by the organised banking system. This has made monetary policy of the RBI (specially tlie bank rate policy) almost ineffective. Besides, there is no all India money market in its true sense though there are only reasonably developed local money markets.

2) Difference in Rates of Interest: In India, interest rates prevailing in different parts of the country are not uniform, i.e., there is coexistence of high as well as low interest rates in different parts of the money market. Even the rates of interest charged by banks differ widely depending upon tlie locality in which they function, the type of security that is offered, the nature of the advances and the competition they have to face. Besides, interest rates during busy season are always higher than what they are during slack season. Another peculiar feature of the Indian money market has been that short-term interest rates are higher than long-term interest rates. However, there has been some improvement in this regard in recent years.

3) Relatively Under Developed Banking Habits: Even after considerable branch expansion, the use of cheques and credit instruments is somewhat less popular. People prefer cash transactions. Besides, hoarding is a popular habit in India, specially in rural and semi-urban areas. This has led to investments in gold and silver ornaments and other **non-monetary assets.**

4) 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 the busy season. Widespread poverty and huge population in India has resulted in low per capita income which has limited the capacity to save. Apart from this. the existence of black money has also considerably reduced the supply of financial resources in the Indian money market.

5) Absence of an Organised Bill Market: In spite of the New Bill Market Scheme of the RBI in the year 1970, organised bill market is yet to fully develop in India. It is due to a variety of reasons like: (i) lack of uniformity in drawing bills between different parts of the country, (ii) general preference for cash transactions, (iii) high stamp duty on usance bills, etc.

6) Inadequate Banking Facilities: Even after expansion of branch banking in the post-nationalisation period, the money-lenders still continue to be the primary source of credit to the Indian farmers and village artisans. This has hampered the process of mobilisation of small savings in the countryside. Apart from this, lack of clearing house facilities and of specialised banks to provide credit to small and tiny sectors are some of the other problems faced by Indian money market.

## 9.5.2 Role of RBI in Tackling the Problems

The Bill Market Scheme was introduced in 1952 by the RBI to grant loans to commercial banks against approved usance bills of their customers. To provide loans liberally to genuine exporters in 1958, this facility was extended to cover export bills as well. The New Bill Market Scheme was introduced in 1970 to revitalise the money market and eliminate certain defects of the 1952 Bill. The new bill scheme proved to be a major step in creating a genuine bill tnarket in India. Some of the shortconlings of the money market have been overcome after nationalisation of commercial hanks and introduction of the New Bill Market Scheme like expansion of branch banking in semi-urban and rural areas, inter-linking of different parts of the money market, rationalisation of interest rates, and reduction in seasonal stringency of money. However, the RBI has not been able to achieve the desired results as the new scheme pravides benefits to scheduled banks only and it remained concentrated mainly in the fields of trade and industry and has failed to help the agricultural sector. Moreover, the banks have to fulfil many prerequisites to avail of the rediscounting facility.

Hence, a lot more remains to be done by both the Government as well as the RBI to improve the working of the money market so that India has a really developed money market.

## 9.5.3 Suggestions fur Improvement

In order to improve the functioning of the money market the following steps need to be initiated by the RBI:

1) Regulation **of Indigenous** Banking: For proper organisation of the Indian money market, registration of indigenous bankers may be made compulsory. They should be brought under the control of RBI and should be provided with loan facilities.

2) Standardisation **of Hundis:** In order to popularise commercial bills, it is essential to standardise indigenous Hundies and bills so that uniformity of rules can be achieved with regard to the contents, language and usage. This will help in developing the bill market in the real sense.

3) Expansion of Rediscounting Facilities: For wider use of bills, the RBI should offer all sorts of facilities for rediscounting of bills. This will help in expansion of financial activities in the money market and reduce stringency of funds as well.

4) Clearing House Facility: For expansion of banking services, it is essential to expand clearing house facilities throughout the country. For this purpose, the number of clearing houses should be increased and improved on the pattern in which European clearing houses function,

5) **Lowering** Stamp Duty: To popularise the use of bills of exchange, the stamp duty should be reduced to a reasonable level.

6) Other Measures: In addition to the above steps, the following measures may also help in improving the money market in India:

i) Establishment of acceptance houses and discount houses.
ii) Expansion of the functions of all India Bankers Association.
iii) Development of a system of agricultural bills against standing crops.
iv) Cheaper and quicker transfer of funds facility.

**Check Your Progress C**

1) State whether the following statements are True or False.
   i) Indian money market may not be as organised as any developed money market but it is definitely equally stable and elastic.
   ii) Various constituents of Indian money market compete more than cooperate with each other.
   iii) The dominance of money-lenders in Indian money market remains almost intact even after expansion of banking in India.
   iv) Indigenous banking sector should also be brought under the control of RBI.
   v) Uniform rates of interest prevail in different parts of our country.

2) **Fill in the blanks:**
   i) RBI introduced the New Bill Market Scheme in the year ...............
   ii) Black money in India has significantly ..............the supply of financial resources in the money market.
   iii) The organised and unorganised sectors of Indian money market are completely .............. from each other in their financial activities.
   iv) The Indian money market suffers from ..............of funds.

## 9.6 LET US SUM UP

The money market is one of the most important institutions in a modern economy. The industrial growth and expansion of trade, particularly foreign trade, are greatly facilitated by the existence of a developed money market. The usefulness of the money market is not limited to business and industrial sectors but is available also to the state and the central bank authorities to implement their policies effectively for realising desired goals of economic activity.

Money market may be distinguished from the capital market. The money market is the collective name given to various firms and institutions which deal in short-term credit, i.e., near money assets. The capital market is concerned with the supply of long-term investiblc funds.

The Indian money market is composed of two segments—organised and unorganised. The organised segment comprises call money market, bill markct, commercial hanks, cooperative and rural banks, post office savings banks and registered chit funds, The RBI is the leader of the organised money market. The unorganised segment includes indigenous banks and the money-lenders.

The Indian money market cannot be termed as a developed money market like the London and New York money markets are. The presence of a large unorganised sector, lack of developed bill market, lack of banking facilities in the rural areas and stringency of funds specially in busy season have resulted in keeping Indian money market underdeveloped,

In order to tide over this difficulty, the RBI introduced a New Bill Scheme in the year 1970. The Government also nationalised 20 major commercial banks to help RBI to tighten its control on the money market. Though various steps initiated so far have definitely helped in improving the performance of the money markct, a lot more remains to be done. In this regard the following suggestions will be worth consideration and implementation by the RBI: popularising the use of hills by standardisation of hundis, promotion and expansion of bill market: regulation of indigenous bankers and money-lenders, creation of a network for clearing house facilities, lowering of stamp duty on usance bills, etc. These measures will go a long way to enhance the effectiveness of monetary policy of the RBI and help develop the Indian money market.

## 9.7 KEY WORDS

Acceptance Market: Refers to the market for banker's acceptances involved in trade transactions.

Call Money: Credit facility for a very short duration, not exceeding seven days.

Capital Market: Concerned with the supply of and demand for long-term investible funds.

**Collateral Loan:** A loan offered against securities like stocks, bonds, merchandise, etc.

**Indigenous Bankers:** Those dealing in Hundis and promissory notes.

Money Market: Refers to the institutional arrangements facilitating borrowing and lending of short-term funds.

**Treasury** Bills: Bills issued by RBI on behalf of the Government.

Usance Bills: Bills with a time specified maturity.

## 9.8 ANSWERS TO CHECK YOUR PROGRESS

A 1) i) short ii) credit instruments iii) functional
2) i) False ii) False iii) True iv) True

B 1) False ii) False iii) True iv) False v) True
2) i and iv

C 1) i) False ii) True iii) True iv) True v) False
2) i) 1970 ii) reduced iii) separate iv) shortage

## 9.9 TERMINAL QUESTIONS

1) What is meant by money market? Discuss the significance of money market in a modem economy.
2) Discuss various constituents of money market and their functioning in India.
3) Discuss various characteristics of a developed money market. Can Indian money market be termed as developed money market?
4) Distinguish between money market and capital market. Highlight the drawbacks of Indian money market which make it an underdeveloped money market.
5) Write the characteristics of Indian money market. Outline the measures to improve the functioning of Indian money market.

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. These are for your practice only.

## SOME USEFUL BOOKS

Gupta, S.B., 1982. *Monetary Economics*, S. Chand & Co: New Delhi. (Chapters)

Mishra, S.K., 1990. *Money, Income and Financial Institutions*, Pragathi Publications: Delhi. (Chapters 15-18, 20, 21, 23)

Mithani, D.M., 1990. *Money Banking International Trade and Public Finance*, Himalaya Publishing House: Delhi. (Chapters 11, 13, 14, 16)

Sundaram, K.P.M., 1989. *Money, Income and Financial Institutions*, Sultan Chand & Sons: New Delhi. (Part II Chapters 1-7, Part V Chapters 2 & 6)