# UNIT 2 : INDIAN MONEY MARKET

## UNIT STRUCTURE


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## 2.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- discuss the structure of Indian Money Market
- explain the instrument of Indian Money Market
- explain the defect of Indian Money Market
- discuss the Bill Market

## 2.2 INTRODUCTION

The Money Market is a very important segment of the Indian financial system. It is the market where short term monetary assets are dealt in to raise short term requirements of funds and/ or to park short term surpluses. The main characteristic of the Money Market is the liquid nature. The money market transactions may range from overnight to one year. It has minimum transaction cost. This unit encompass the structure of the Money Market that has undergone vast changes in the last decade. In this unit, we are going to discuss the different instruments and the defect of Indian Money

Market. The unit also discuss the bill market. Thus, you will be able to understand through this unit the structure, instrument as well as the defect of the Indian money market.

## 2.3 MEANING OF MONEY MARKET

The money market is the market which deals with short term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short term funds.

**Participants of money market:**

Following are the institutions which can take part in money market:

a. Reserve Bank of India
b. Commercial banks
c. Central and State Government
d. Public sector undertaking
e. Private sector companies
f. Non-banking financial institutions
g. Mutual funds
h. Insurance companies

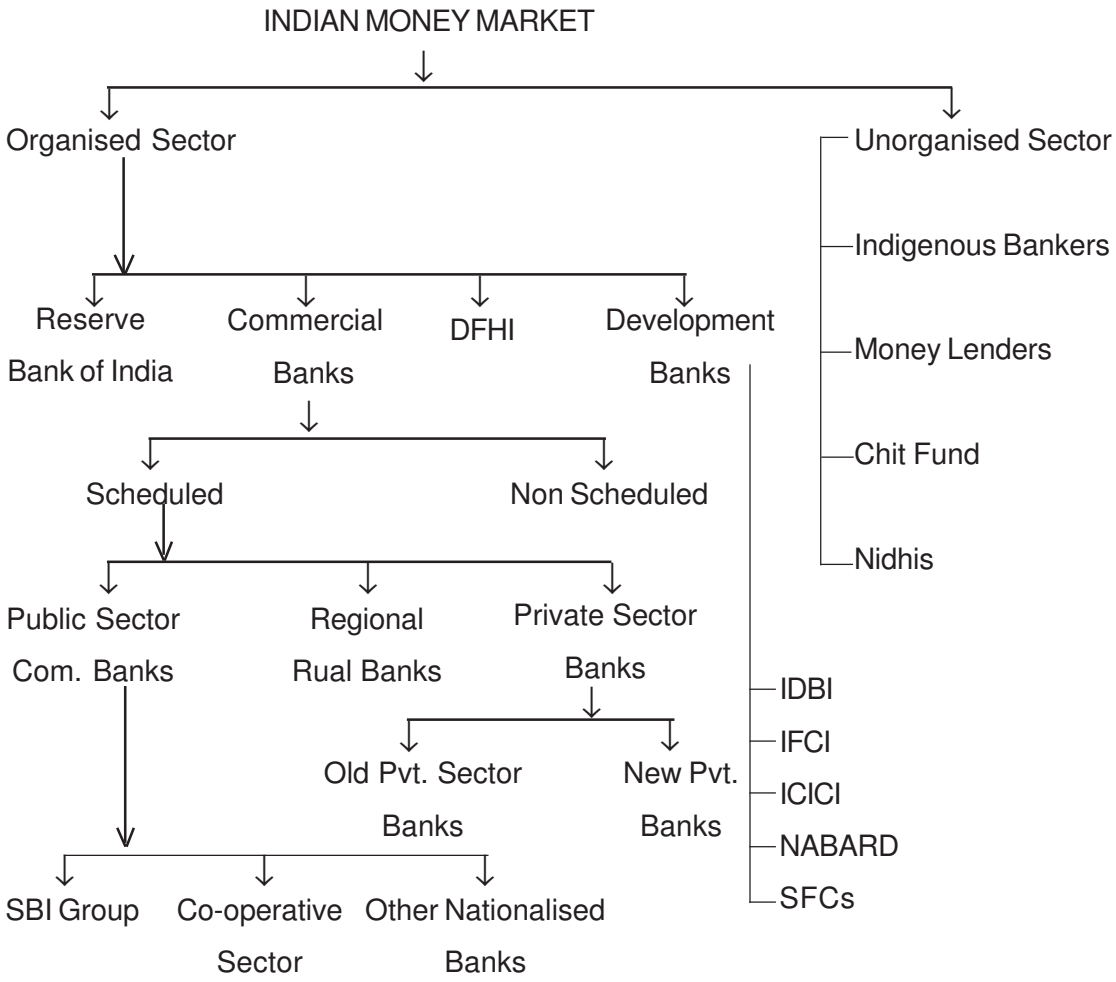
**BASIC FUNCTIONS OF MONEY MARKET:**

1. To provide efficient mechanism of liquidating for commercial banks, non-banking financial institutions, business firms and other investors.
2. To bridge between short term surpluses and deficits.
3. To provide a realistic price for short term money.
4. To provide a platform for the Central bank of the country to control and manage the money supply.

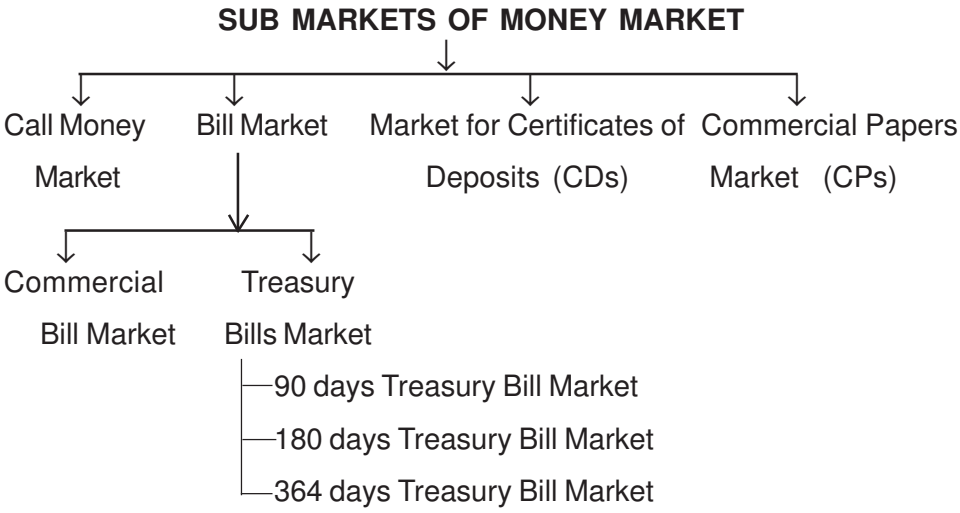
## 2.4 STRUCTURE OF INDIAN MONEY MARKET

The Money Market is the close substitutes for money with the short term time span from overnight to year. The Indian Money Market consists of both organised and unorganised segment. The organised segment includes the Reserve Bank of India, State Bank of India, Public Sector as well as Private Sector Banks, Regional Rural Bank, Commercial Banks including

Foreign Banks, Non-Scheduled Commercial Banks and other Non-Bank Financial Intermediaries such as LIC, GIC, and UTI etc. On the other hand, the unorganised segment consists of indigenous bankers, money lenders and other non-bank financial intermediaries.




Indian money market can be divided into various sub-markets depending on their nature and scope of the transactions and the features of the instruments.






**CHECK YOUR PROGRESS**

**Q 1:** Mention two unorganised sectors of Indian Money Market.

i) .....

ii) .....

## 2.5 MONEY MARKET INSTRUMENTS

Money Market instruments mainly include Government securities, securities issued by private sector and banking institutions—

1. Government Securities
2. Money at Call and Short Notice
3. Inter-Bank Participation certificate
4. Treasury Bills
5. Certificates of Deposits
6. Commercial Bills
7. Commercial Paper
8. Repo

***1. Government Securities:*** The Reserve Bank of India issues securities on behalf of the Government. The term Government Securities includes Central Government Securities, State Government Securities and Treasury Bills. The different types of Government Securities are—

The Government dated securities can be purchased for a minimum

amount of Rs. 10,000/- and the Treasury bills of Rs. 25,000/- and in multiple thereof. The State Government Securities can be purchased for a minimum amount of Rs.1,000/-.

| **Dated Securities** | **Zero Coupon Bonds** | **Partly Paid Stock** | **Floating Rate Bonds** | **Bonds with Call/ Put Option** | **Capital Indexed Bonds** |
|---|---|---|---|---|---|
| Issued at face value | Issued at discount to the face value | Issued at face value, but paid in installments over a period | Issued at face value | Abond issued at call and put option | Issued at face value |
| Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security | Do not carry any interest rate | Interest or coupon rate is fixed at the time of issuance, and remains constant till redemption of the security | Interest rate is fixed as a percentage over a predefined benchmark rate which may be Treasury bill, bank rate etc at the time of issuance | This bond is due for redemption in 2012 and carries a coupon of 6.72% | Interest rate is fixed as a percentage over the wholesale price index at the time of issuance. |
| The tenure of security is fixed | The tenure of security is fixed | The tenure of security is fixed | The tenure of security is fixed | This bond has been priced in line with 5 year bonds | The tenure of security is fixed |
| The security is redeemed at par (face value) on its maturity date | The security is redeemed at par (face value) on its maturity date | The security is redeemed at par (face value) on its maturity date | The security is redeemed at par (face value) on its maturity date | This bond has been priced in line with 5 year bonds | The principal redemption is linked to the Wholesale Price Index. |

**CHECK YOUR PROGRESS**



**Q 2:** Mention three types of Government Securities.

i) .....

ii) .....

iii) .....

***2. Money at Call and Short Notice:*** Call money or call deposits are that money which is lent on condition to repay on call. Notice money refers to the money lent and repaid on a certain day's notice from the

lenders. Banks borrow for a variety of reasons to maintain their cash reserve ratio, heavy payments, to maturity mismatch etc. Money at short notice is for a maturity upto 14 days. The main participants are banks and all India financial institutions as permitted by RBI.

A minimum size of Rs. 20 crores for each transaction was permitting the participation of the corporate in the call money market. The Discount and Finance House of India (DFHI) enhanced the activity of Call Money Market and Short-term Deposit Market. It allows lending and borrowing of funds. The borrowers are essentially the banks. It can operate outside the purview of the provision of the ceiling rates fixed by the Indian Banks Association. The different participants that lend fund in the market are like GIC, IDBI, NABARD etc. The private Mutual funds were also participating in the market. The DFHI ascertains the settlement between the lender and the borrower about the availability of fund and the amount needed and the exchanges. It also provides advice regarding the interest rates applicable to them.

Here, the call rates are more volatile as they are determined by the interaction of demand and supply of funds in the market which is based on the maintenance of Cash Reserve Ratio by the banks. There are two call rates maintained in India i.e. Inter-bank call rate and the lending rate of DFHI.

3. ***Inter-Bank Participation Certificate:*** Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. This instrument is issued as per RBI guidelines for two purposes:

a. on risk sharing basis

b. without risk sharing

Inter-Bank Participation without risk sharing can have tenure of 90 days only where, the issuing bank as borrowing and the participating bank advances to the banks. In case of risk sharing basis, the lender bank shares losses with the borrowing banks by mutually determining the interest rate. The tenure may be for 90 to 180 days.

4. ***Treasury Bills:*** Treasury Bills are discounted securities issued at a discount face value as per the short term requirement of the Government of India. RBI issues Treasury Bills on a prefixed day and at a fixed amount. There are four types of Treasury Bills:

   a. 14-day Tbill maturity is in 14 days.

   b. 91-day Tbill maturity is in 91 days.

   c. 182-day Tbill maturity is in 182 days.

   d. 364-day Tbill maturity is in 364 days.

   These are highly liquid money market instruments. It is a zero default risk bearing paper. It helps in deployment of idle funds for very shorts periods as well.

5. ***Certificates of Deposits:*** These are issued according to the guidelines of the Reserve Bank of India in dematerialized form or Usance Promissory Note for the fund deposited at a bank or other financial institution. It is a negotiable money market instrument whose minimum deposit should be Rs.1 lakh and the multiples of Rs. 1 lakh thereafter. The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year. But, it should not be less than 1 year and exceed 3 years for financial institution.

6. ***Commercial Bills:*** These are the bills accepted by the buyer for goods and services on credit from the seller and which may be kept upto the due date and encased by the seller or may be endorsed to a third party. The bills being bills of exchange may be discounted with the banks or financial institutions. These bills may again be the rediscounted at the bank.

7. ***Commercial Papers (CP):*** It is an additional unsecured money market instrument to the investors as a source of short term borrowing. This instrument is issued in the form of a promissory note or dematerialized form. Every issuer has to appoint an Issuing and Paying Agent (IPA) for the issue of commercial papers and only a scheduled bank can act as an IPA for issuance of CP. The investor are given the Issuing and Paying Agent (IPA) certificate as well as issued physical certificates or arrangement is made for crediting the CP to the investor's account

with a depository. The CP issued for a maturity period between a minimum of 7 days and a maximum up to one year from the date of issue in the denomination of Rs. 5 lakh or multiples thereof. The main purposes of introducing CP are—

a. To enable the high level corporate borrowers such as leasing and financing of companies, manufacturing and financial institutions etc.

b. To diversify the sources of short term borrowing

c. To provide instrument for bank and financial institution in the money market.

8. ***Repo:*** This money market instrument helps in collateralised short-term borrowing and lending through sale or purchase operation in debt instruments. Here the securities are sold by the holders to the investors with an agreement to repurchase them at a predetermined rate and date.

On the other hand, under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



**CHECK YOUR PROGRESS**

**Q 3:** Mention four types of Treasury Bills.

i) .....

ii) .....

iii) .....

iv) .....



***Indigenous Bankers:*** These are individuals or private firms who receive deposits and give loans and there by operate as banks.

## 2.6 DEFECTS OF INDIAN MONEY MARKET

Money market is the market for lending and borrowing of short term funds. A well developed money market denotes an implementation of effective monetary policy. But the Indian money market suffers from many weaknesses.

1. ***Lack of integration:*** The Indian Money Market is divided into two sectors viz, the organised and unorganised money market. But both

the markets are completely separate from each other. They are working independently and have little effect on each other. RBI is fully effective in controlling the organised sector. But, it has very less control on the unorganised sector.

2. ***Lack of rational interest rates structure:*** The Indian Money Market exist too many interest rates. For example, the deposit and lending rates of commercial banks, the borrowing rate of Government etc. In the past these created excess demand for credit and the RBI had to rely often on cash reserve ratio. Though the RBI has tried to bring rationality in the interest rates, the situation in the Indian money market is still not effective.
3. ***Existence of Unorganised Money Market:*** The existence of the unorganised sector in money market still prevails in Indian Money Market. The indigenous banker does not make any distinction between short term and long-term finance. They have no coordination with each other and have no link with other banking sectors. They do not follow any sound banking regulations. The RBI has no control over these bankers.
4. ***Absence of an organised bill market:*** In Indian Money Market, there is an absence of adequate bill market. There is an absence of commercial bill market or a discount for short term commercial bills. There are many factors responsible for the underdeveloped bill market such as (i) relying more on cash transaction, (ii) cash credit of commercial bank, (iii)seller's limited use of bills, (iv) imposition of heavy stamp duty, (v) absence of acceptance houses etc.
5. ***Shortage of funds in the Money Market:*** The lack of banking habit, inadequate banking facility, less saving habit, etc created have shortage of fund in the money market. On the other hand, the increasing demand for loanable funds in the money market far exceeds its supply.
6. ***Inadequate banking facility***: Now-a-days, the commercial banks have opened many new branches of banking facilities. But, it still leaves much scope for further development. In a developing country like India, people live below poverty line and have less saving habit. Their savings

are very small and they do not have much access to banking facilities till now.

7. ***Seasonal Stringency of Money:*** During the part of the year the interest rates become high due to the increasing demand for funds in the money market for the operation in the agricultural sector. Basically, it is seen in the period from October to June.



**CHECK YOUR PROGRESS**

**Q 4:** Mention four defects of Indian Money Market.

i) .....

i i) .....

iii) .....

iv) .....

## 2.7 MEASURES TO IMPROVE INDIAN MONEY MARKET

The major drawback of India Money Market is its high volatility. Gradually the money market transaction is increasing. But, on the recommendation of the Sukhmoy Chakravarty Committee (on the review of the working of the Monetary System) and the Narasimham committee (on the Report on the working of the financial system in India, 1991), RBI initiated a series of reform in Indian Money Market. The following are some of the measures undertaken,

1. ***Introducing new money market instrument:*** Many new money market instruments are introduced like Commercial Papers, Certificates of Deposits, 182-day Treasury, 364-day Treasury etc. The Discount and Finance House have also developed. These facilitate different short term borrowings to the different borrowers to collect fund as and when required to maintain their financial position.
2. ***Relaxation of interest rate regulations:*** The all types of interest rates like lending as well as deposit rates of the banks and financial institution are controlled and regulated by RBI. But, gradually the interest rates of the bank loans are controlled by the market forces which result

decontrolled of it.

3. ***Remitting the stamp duties:*** In August 1989, Government remitted the stamp duty. But, it is not effective till it discourages the cash credit system in favour of using the bill system.
4. ***Sector specific refinance:*** Export credit refinance and general refinance are two refinance schemes that are in operation in the current financial system. The refinance is used by the central bank to control credit conditions and the liquidity positions in the system. But if the excessive funds supplies into the system do not result any the development then it could be highly distorted one.
5. ***Introduction of repo:*** This is used by the banks for short term liquidity through sale or purchase of debt instruments. It is an agreement to repurchase them at a predetermined rate and date between the RBI and commercial banks.
6. ***Introducing Money market Mutual Funds:*** The Money Market Mutual Funds were introduced in April 1991. The collection of the small savings invested generate short term avenues to the different investors.
7. ***Setting the Discount and Finance House in India:*** The DFHI equilibrated the surplus of fund and the deficit amounts of the banks. The DFHI helps in lending and borrowing of funds to the different banks as well as financial institutions.



**CHECK YOUR PROGRESS**

**Q 5:** Mention five measures to improve the Indian Money Market.

i).....

ii) .....

iii) .....

iv) .....

v) .....

## 2.8 Bill Market

A bill is nothing but a promise by the borrower to the creditor to pay. These bills should be drawn on and accepted by the purchaser's bank. The

date of repayment of bank's loan is fixed. It is of three types: i.) promissory notes, ii.) bills of exchange, and iii.) treasury bills. This is a market of short term bill to meet short term financial needs of individual, companies etc. The commercial banks use these bills to maintain their financial positions of the bank by disposing or rediscounting it in the Reserve Bank of India. The Reserve bank of India has been making efforts to develop the bill market. These are of self- liquidating nature. Now-a-days, all commercial banks as well as the public sector banks are eligible for to offer the bill of exchange for rediscounting to the Reserve Bank of India.



## 2.9 LET US SUM UP

In this unit we have discussed the following -

- Money Market is a market for short term funds. Money is raised and deployed for short term in this market.
- The Money Market is the close substitutes for money with the short term upto one year.
- A minimum size of Rs. 20 crores for each transaction was permitted in the participation of the corporate in the call money market.
- The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year.
- On the recommendation of the Sukhmoy Chakravarty Committee and the Narasimham committee, RBI initiated a series of reform in Indian Money Market.
- To provide safety, liquidity and return, MMMFs are formed which collect the small savings of a large number of savers and invest them in the capital market.
- Gilt-edged (Government) Securities security have great demand for the banks to maintain the Net Demand and Time Liquidities (NDTL) position of the bank through its buying and selling.
- Under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date.



## 2.10 FURTHER READINGS

1) Batra G.S. (2002). Financial services and markets. New Delhi, Deep and Deep Publication Pvt. Ltd.

2) Mishkin,Frederic S. (2007) Financial Markets and Institutions. New Delhi, Pearson Education Ltd.

3) Srivastava, R.M. (2009). Management of Indian financial institutions. New Delhi, Himalaya Publishing House.

4) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.



## 2.11 ANSWERS TO CHECK YOUR PROGRESS

**Ans to Q No 1:** Two unorganised sectors of Indian Money Market are:

i. Indigenous Bankers

ii. Money Lenders

**Ans to Q No 2:** Three types of Government Securities are:

i. Dated Securities

ii. Zero Coupon Bonds

iii. Partly Paid Stock

**Ans to Q No 3:** Four types of Treasury Bills are:

i. 14-day Tbill maturity is in 14 days.

ii. 91-day Tbill maturity is in 91 days.

iii. 182-day Tbill maturity is in 182 days.

iv. 364-day Tbill maturity is in 354 days.

**Ans to Q No 4:** Four defects of Indian Money Market are:

i. Lack of integration

ii. Lack of rational interest rates structure

iii. Existence of Unorganised Money Market

iv. Inadequate banking facility

**Ans to Q No 5:** Five measures to improve the Indian Money Market are:

i. Introducing new money market instrument

ii. Relaxation of interest rate regulations

iii. Remitting the stamp duties

iv. Sector specific refinance

v. Introduction of repo



## 2.12 MODEL QUESTIONS

**Q 1:** What do you understand by Money Market? What are the constituents of the Indian Money Market?

**Q 2:** Discuss the different Money Market instruments?

**Q 3:** Discuss the defects of Indian Money Market?

**Q 4:** What are the measures to improve the Indian Money Market?

**Q 5:** Write short notes on:

a. Government Securities

b. Bills Rediscounting

c. Money Market Mutual Funds

d. Treasury Bills

e. Certificates of Deposits

f. Commercial Paper

g. Gilt-edged (Government ) Securities

h. Bill Market.

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