B.A./B.Sc. (H) in Economics

Study Materials for Money & Banking (CC12), Semester V (H) -prepared by Dr. Labanya Pal, Assistant Professor of Economics, Suri Vidyasagar College.

MONEY MARKET

Concept of Money market

Financial markets of an economy may broadly be divided into two major parts. One is money market and the other is capital market. Money market is the market for short-term loan or financial assets having a maturity period of less than 1 year. It is the centre for dealing in short-term funds. It meets the short-term requirements of borrowers for funds and provides opportunity to lenders for short-term outlets of their surplus funds. In particular, money market meets the working capital needs of business firms. It does not refer to a particular place; it includes all individuals, institutions and intermediaries dealing in short-term funds. Transactions between borrowers and lenders may take place through telephone, telegraph, mail and agent. No personal contact or presence of the two parties is essential for negotiations in a money market. However, a geographical name may be given to a money market according to its location. For example, London money market operates from Lambert Street, while New York money market operates from Wall Street. In India, Mumbai money market operates from Dalal Street. Kolkata money market operates from Lyons range, and so on. Following Crowther, we may define money market as follows:

'The money market is a collective name given to the various firms and institutions that deal in various grades of near money[1]'.

Near money refers to short-term funds or financial assets with very high degree of liquidity, that is, which can easily be converted into cash.

General Features of Money Market

Money markets of developed and underdeveloped countries have different features. However, as money markets, they share some common features too. To clarify the concept or definition of money market, we may mention some general features of money market. The following are the general features of money market:

• Money market is purely a market for short-term funds or financial assets called near money.

• Money market deals in financial assets having a maturity period of less than one year only.

• It deals in only those assets which can be converted into cash readily without loss and with minimum transaction cost.

• Generally transactions in money market take place through phone, that is, oral communication. Relevant documents and written communications can be exchanged subsequently. There is no formal place of money market such as stock exchange or stock market as in the case of a capital market.

• Transactions have to be conducted without the help of brokers.

- Money market is not a single homogeneous market. It consists of several sub-markets, such as, call money market, commercial bill market, Treasury bill market, market for commercial papers (CPs), and so on. Each sub-market specialises in a particular type of short-term asset. The main players of the money market are the central bank, commercial banks, discount houses and acceptance houses. Commercial banks generally play a dominant role in the money market.

ORGANISED AND UNORGANISED MONEY MARKETS

Money market is the market which provides short-term finance to the business firms and individuals, where short-term refers to a period of less than one year. Now, according to the strength and stability, the money market may be divided into two sectors: organised sector and unorganised sector. The members of organised sector are commercial banks, co-operative sector banks, and sub-markets such as call money market, bill market, and short-term loan market. The unorganised sector comprises indigenous bankers, money lenders, finance brokers, nidhis, chit funds, and so on. The organised sector has a definite or specific set of rules of operation. However, the unorganised sector has no definite set of rules of functioning. Further, the organised sector of money market of a country is under the direct control and supervision of the central bank of that country. But the unorganised sector of the money market is not under the direct control and supervision of the central bank. The formal distinctions between organised and unorganised money markets may be presented in terms of Table 1.

Table1. Organised and unorganised money markets

Organised	Unorganised
1. Organised money market is that part of money market which is under specific rules and regulations.	1. Unorganised money market is that part of money market which is not governed by specific rules and regulations.
2. The main players are commercial banks, discount houses, co-operative banks, bill markets, and so on.	2. The main players are village money lenders, businessmen, indigenous bankers, nidhis, chit funds, and so on.
3. The rate of interest is relatively low.	3. The rate of interest is relatively very high.
4. It is under the direct control and supervision of the central bank.	4. It is not under the direct control and supervision of the central bank.
5. The main instruments are call money, Treasury bills, commercial bills, and so on.	5. The main instruments are darshani hundis (sight bills) and muddati hundis (usance or time bills).
6. There are specific rules for security and hypothecation against credit.	6. There is no specific rule for security and hypothecation against credit. It varies from region to region and from creditor to creditor.
7. Small as well as large corporate houses and the government are generally the customers of credit.	7. Small businessmen and consumers are generally the customers of credit.
8. Personal acquaintance does not influence the terms of credit.	8. Personal acquaintance or past performance to repay debt may influence the terms of present credit.

OBJECTIVES OF A MONEY MARKET

A money market has some important objectives. We briefly mention them as follows:

• To provide an opportunity to employ short-term surplus funds of surplus-spending units.

• To provide a way for overcoming short-term deficits of deficit-spending units.

• To assist the central bank to influence and regulate liquidity in the economy through its activities in the market.

• To provide a reasonable access to users of short-term funds to meet their requirements quickly, adequately and at reasonable rates.

FUNCTIONS OF MONEY MARKET

We know that a money market is for short-term loans or financial assets having a maturity period of less than 1 year. In any country, money market performs some important functions and thus helps in economic development of the country. Following functions of money market will explain its role and importance in economic development of a country.

Provision of Short-term Funds

Money market helps business firms to continue their production in an uninterrupted manner. It provides short-term funds to the public and private organisations. It thus finances their working capital requirements and helps to continue their activities without any interruption.

Use of Surplus Funds

Money market gives an opportunity to the holders of short-term surplus funds to utilise those funds. It provides an opportunity to banks and other financial institutions to use their surplus funds profitably for a short period.

Less Dependence of Banks on Central Bank

In a developed money market, commercial banks can call back some of their loans from the money market in the hour of need for cash. Hence, their dependence on central bank for cash decreases. Commercial banks can then concentrate on their lending policy more independently. The central bank also feels free while executing its monetary policy. All these indirectly help in economic development of a country.

Helpful for Government

Money market helps the government to borrow short-term funds at low interest rates on the basis of Treasury bills. Thus, the government can meet the short-term need for cash through the money market. This helps the government to implement its short-term economic policies more successfully.

Helpful for Monetary Policy

A well-developed money market helps in the successful implementation of the monetary policy of the central bank. If the money market is developed, monetary policy of the central bank becomes more effective. Specially, the policy of open market operations becomes very successful. Hence, the central bank can help in the economic development of a country through its successful monetary policy.

Financial Mobility

The money market increases financial mobility of a country by facilitating the transfer of funds from one sector to another. This mobility is very important for the development of trade and industry of an economy.

Liquidity and Safety

Money market promotes liquidity and safety of financial assets. On the one hand, it encourages savings and on the other hand it encourages investment. It thus promotes economic development of a country.

Equilibrium between Demand for and Supply of Funds

Money market brings equilibrium between demand for and supply of loanable funds. This is done by channelising savings into productive investment. Money market, thus, helps in rational allocation of resources and promotes economic development.

Economy in the Use of Cash

Money market deals in near-money assets and not in money proper. It thus helps in economising the use of cash in transaction of goods and services. This raises the volume of transactions and increases the financial mobility in the economy. This again helps in economic development in various ways.

Increase in Savings and Investment

Money market helps in the mobilisation of saving. It channelises that saving into productive investment. It thus fosters economic development of a country. It also helps in the expansion of industry and trade of the country.

MONEY MARKET INSTRUMENTS

In the context of financial analysis, the word instrument refers to financial paper or financial security. It includes a wide range of financial assets including shares and debentures. Hence money market instruments refer to those financial papers or assets which are transacted in the money market. There are mainly five (05) instruments in the money market. They are as follows:

- Call money/Notice money
- Treasury bill
- Commercial bill
- Commercial papers (CPs)
- Certificates of deposits (CDs). Let us discuss them one by one

Call Money/Notice Money

Call money/Notice money refers to extremely short-period loans, viz., 1-14 days. Technically, if the money is lent for 1 day, it is known as call money. If the money is lent for 2-14 days, it is called notice money. However, both types of money are popularly called call money. These loans are repayable on demand at the option of either the lender or the borrower. Hence it is called call money. The market for such extremely short-period loans, that is, for call money is called call money market. The participants in this call money market are mainly the banks. Banks with surplus funds lend to other deficit banks in the call money market. Although the borrowers and lenders are mainly the banks, some financial institutions such as LICI and UTI are sometimes allowed to provide such call loans in order to earn interest. As these call loans have very short maturity period, they are highly liquid and close to money. The rate of interest paid on call loans is known as call rate. It is highly unstable and very sensitive to changes in demand for and supply of call loans. In recent years, the size of call money market in India has expanded remarkably.

Treasury Bill

A Treasury bill is a promissory note issued by the government under discount for a specified period. The specified period is less than 1 year. The government promises to pay the specified amount to the bearer of the Treasury bill on the due date. As we have mentioned, Treasury bills are bought and sold on discounted basis. This implies that the price of the bill is below its face value by the amount of interest due on the bill. A Treasury bill is purely a finance bill since it does not arise out of any trade transaction. The bill does not require any endorsement or acceptance since it is a claim against the government. Treasury bills represent short-term borrowing of the government. The important qualities of Treasury bills are high liquidity, no risk of default, assured yield, low-transaction cost, ready availability, and so on. On the basis of periodicity, Treasury bills may be divided into three main categories, namely, 91-day Treasury bills, 182-day Treasury bills and 364-day Treasury bills.

Commercial Bill

A commercial bill is a trade bill which arises out of a genuine trade transaction or commercial transactions. As soon as goods are sold on credit, the seller draws a bill on the buyer for the due amount. The buyer accepts and endorses it; it implies that he agrees to pay the amount mentioned in the bill on a certain specified date. A commercial bill is also called a bill of exchange. Thus, a commercial bill or a bill of exchange is a written order from the creditor to the debtor, to pay a certain sum, to a certain person, after a certain period. It is self-liquidating and negotiable credit paper. Its maturity period is generally 91 days. Commercial bill is a very important credit paper for providing short-term finance to trade and industry. It can be resold any number of times. For all these reasons, banks prefer to invest in commercial bills.

Commercial Papers (CPs)

Commercial paper is a relatively new money market instrument in India. It was launched on 1 January 1990. Commercial paper is a credit paper. Any public sector or private sector company can issue commercial papers (CPs). The maturity period of CPs ranges between 15 days and 1 year. The CPs are issued at a discount to their face value. This means that the price of CP is below its face value by the amount of interest due on this credit paper. The discount rate is freely determined by the issuing company. Commercial papers (CPs) are freely transferable. However, commercial papers have few limitations also. Usually, CPs are unsecured instruments. This may act as a disincentive to the investors. Further, there is some restriction on the minimum size of investment in CPs. This minimum size is quite high to an individual and small investor. Hence, generally the individuals and the small companies cannot participate in the transactions of CPs. The major holders of CPs are banks. Recently, the primary market for commercial papers has become fairly popular. Yet, a secondary market of CPs has not fully developed in India. With institutions such as Discount and Finance House of India (DFHI) and some agents dealing in CPs, it may be expected that the secondary market of CPs will grow in Indian money market in near future.

Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are another type of credit instrument in the Indian money market. A certificate of deposit is a document of title to a time deposit. It is transferable from one party to another. CDs are short-term deposit instruments issued by banks and other financial institutions. They are generally issued to raise large sums of money. They are negotiable and bear specific face value and maturity. Due to their negotiable nature, CDs are also called Negotiable Certificates of Deposits. The subscribers of CDs may be individuals, corporate houses, trusts, associations and non-resident Indians (NRIs).

There are some advantages associated with CDs. CDs are negotiable or marketable short-term instruments. They can be sold and traded in the secondary market. The major merits of CDs are their liquidity and marketability. They are virtually riskless in terms of default of payment of interest and principal.

The RBI introduced the scheme of CDs in Indian money market in June 1989. We have already mentioned that CDs can be issued to individuals, corporations, companies, trusts, funds and associations. Initially, CDs were highly popular instruments in the primary market. It was mainly due to their higher interest rates compared to normal banking lending rates. However, after 1991, due to the adoption of liberalisation policy by the Government of India, banks are getting funds easily. Hence, interests on CDs have fallen and the market for CDs has not expanded much in the Indian money market. However, many think that there is a potential for the growth of primary and secondary markets for CDs in the Indian money market.

STRUCTURE OF INDIAN MONEY MARKET

The structure/composition of any financial market shows its different sectors and sub-sectors, players or organisations operating in those sub-sectors, financial instruments transacted in different sub-sectors and so on. Thus, while considering the structure/composition of Indian money market, we shall try to highlight the above-mentioned factors. The Indian money market is highly disintegrated and unorganised. In this market, there are mainly two sectors: unorganised sector and organised sector. The unorganised sector includes indigenous bankers, money lenders, finance brokers, private housing companies or nidhis and various chit funds. The organised sector includes organised banking sectors, co-operative sector/banks and some sub-markets. Co-operative sector including co-operative banks may be included in the organised banking sector. However these co-operative banks are run on the basis of the principle of co-operation. Hence, we consider them as a separate group. The unorganised sector is out of the control and supervision of the Reserve Bank of India (RBI) whereas the organised sector is under the control and supervision of the RBI.

The organised banking sector of India includes the Reserve Bank of India (RBI), public sector banks and private sector banks. Public sector banks include both scheduled and non-scheduled banks. Scheduled banks are banks which are included in Schedule 2 of the Reserve Bank of India. They are under the direct control of the RBI. Similarly, private sector banks include both Indian and foreign banks. Apart from them, there are some non-bank financial intermediaries in the Indian money market that also act as intermediaries between borrowers and lenders. Some of them provide short-term loans and, hence, are regarded as members of Indian money market. The organised sector of Indian money market is not a single homogeneous market. Apart from organised banking sector including co-operative banks, it has a number of sub-markets. Important among them are call money market, bill market and acceptance market or short-term loan market. The bill market has again two components, namely—Treasury bill market and commercial bill market. The nature of credit paper traded in each sub-markets is indicated in their names.

In Figure 1, we have shown the structure of Indian money market. Two points may be mentioned in this context. First, in the structure of Indian money market, we see that India has an unorganised sector. In fact, this unorganised sector is quite large. It is outside the control and supervision of the RBI. This has greatly reduced the effectiveness of monetary policy of the RBI. Second, Indian money market has some sub-markets, namely, call money market, Treasury bill market, commercial bill market, market for commercial papers (CPs), market for certificates of deposits (CDs) and acceptance market or short-term loan market. Among them, call money market, Treasury bill market and commercial bill market or simply bill market are the most important sub-markets in Indian money market. Hence, we have discussed these three markets separately in the subsequent sections.

Figure1. Structure of Indian money market