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Money Market in India

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INTRODUCTION

Money Market is a very important segment of a financial system. It is the market for dealing in monetary asset of short-term nature. Short-term funds up to one year and financial assets that are close substitutes for money are dealt in the Money Market. Money Market instruments have the characteristics of liquidity (quick conversion into money),minimum transaction cost and no loss in value. Excess funds are deployed in the Money Market, which in turn is availed of to meet temporary shortages of cash and other obligations. Money Market provides access to providers and users of short-term funds to fulfill their investments and borrowings requirements respectively at an efficient market clearing price. It performs the crucial role of providing an equilibrating mechanism to even out short-term liquidity, surpluses and deficits and in the process, facilitates the conduct of monetary policy. The Money Market is one of the primary mechanism through which the Central Bank (RBI) influences liquidity and the general level of interest rates in an economy. The Bank's interventions to influence liquidity
serve as a signaling-device for other segments of the financial system. The Money Market functions as a wholesale debt market for low-risk, highly liquid, short term instruments. Funds are available in this market for periods ranging from a single day up to a year. Mostly Government, banks and financial institutions dominate this market. It is a formal financial market that deals with short-term fund management. Though there are a few types of players in Money Market, the role and the level of participation by each type of player differs largely.

Government is an active player in the Money Market and in most of the economies; it constitutes the biggest borrower in this market. Both, Government securities (G-secs) and Treasury bill (T-bill) is a security issued by RBI on behalf of the Government of India to meet the latter's borrowing for financing fiscal deficit. Apart from functioning as a banker to the government, the central bank (RBI) also regulates the Money Market and issues guidelines to govern the Money Market operations. Another dominant player in the Money Market is the banking industry. Banks mobilize deposits of savers in lending to investors of the economy. This process is known as credit creation. However, banks are not allowed to lend out the entire amount for extending credit for investment. In order to promote certain prudential norms for healthy banking practices, most of the developed economies require all commercial banks to maintain minimum liquid and cash reserves in form of Statutory Liquid Ratio (SLR) and Cash Reserve Ratio (CRR) framed under
the policies of central banks. The banks are required to ensure that these reserve requirements are met before directing deposits on their credit plans. If banks fall short of these statutory reserve requirements, the deficit amount can be raised using the Money Market. Other institutional players like financial institutions, corporates, mutual funds (MFs), Foreign Institutional Investors
(FIIs) etc. also transact in Money Market to fulfill their respective short term finance deficits and short falls. However, the degree of participation of these players depends largely on the regulations formulated by the regulating authorities in an economy. For instance, the level of participation of the FIIs in the Indian Money Market is restricted to investment in Government securities only.

GROWTH OF MONEY MARKET IN INDIA

While the need for long term financing is met by the capital or financial markets, money market is a mechanism which deals with lending and borrowing of short term funds. Post
reforms period in India has witnessed tremendous growth of the Indian money markets. Banks and other financial institutions have been able to meet the high expectations of short term funding of important sectors like the industry, services and agriculture. Functioning under the regulation and control of the Reserve Bank of India (RBI), the Indian money markets have also exhibited the required maturity and resilience over the past about two decades. Decision of the government to allow the private sector banks to operate has provided much needed healthy competition in the money markets, resulting in fair amount of improvement in their functioning.

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The Indian financial markets remained orderly, notwithstanding the impact of global developments and tight liquidity conditions in domestic markets. Call rate firmed up in step with policy rates and tight liquidity conditions. It mostly remained above the upper bound of the LAF corridor during the third quarter of 2010-11. Both commercial paper (CP) and certificate of deposit (CD) markets remained active as alternative sources of finance. The yield curve for Government Securities (G-Sec) shifted, reflecting expectation of policy rate changes in an inflationary environment. The Indian Rupee appreciated moderately against the US dollar and stock prices rose on the back of strong foreign portfolio inflows. Prices in the housing market in general continued the rising trend during the second quarter of 2010-11.

1.INTER BANK MARKET

Money market denotes inter-bank market where the banks borrow and lend among themselves to meet the short term credit and deposit needs of the economy. Short term generally covers the time period upto one year. The money market operations help the banks tide over the temporary mismatch of funds with them. In case a particular bank needs funds for a few days, it can borrow from another bank by paying the determined interest rate. The lending bank also gains, as it is able to earn interest on the funds lying idle with it. In other words, money market provides avenues to the players in the market to strike equilibrium between the surplus funds with the lenders and the requirement of funds for the borrowers. An important function of the money market is to provide a focal point for interventions of the RBI to influence the liquidity in the financial system and implement other monetary policy measures.

2.RBI INTERVENTION

Depending on the economic situation and available market trends, the RBI intervenes in the money market through a host of interventions. In case of liquidity crunch, the RBI has the

Option of either reducing the Cash Reserve Ratio (CRR) or pumping in more money supply into the system. Recently, to overcome the liquidity crunch in the Indian money market, the RBI has released more than Rs 75,000 crore with two back-to-back reductions in the CRR.

3. LINK WITH FOREIGN EXCHANGE MARKET

In addition to the lending by the banks and the financial institutions, various companies in the corporate sector also issue fixed deposits to the public for shorter duration and to that extent become part of the money market mechanism selectively. The maturities of the instruments issued by the money market as a whole, range from one day to one year. The money market is also closely linked with the Foreign Exchange Market, through the process of covered

interest arbitrage in which the forward premium acts as a bridge between the domestic and foreign interest rates.

4. DETERMINATION OF APPROPRIATE INTEREST FOR DEPOSITS

Determination of appropriate interest for deposits or loans by the banks or the other financial institutions is a complex mechanism in itself. There are several issues that need to be resolved before the optimum rates are determined. While the term structure of the interest rate is a very important determinant, the difference between the existing domestic and international interest rates also emerges as an important factor. Further, there are several credit instruments which involve similar maturity but diversely different risk factors. Such distortions are available only in developing and diverse economies like the Indian economy and need extra care while handling the issues at the policy levels.

Conclusion

Let me conclude. Our experience shows that the development of money market and refinements in operating procedures of monetary policy have moved in tandem. Financial

sector reforms along with Reserve Bank’s emphasis on development of various segments of

financial market enabled shifts in operating procedures based on direct quantity-based instruments to indirect interest rate-based instruments. The Reserve Bank has been able to better transmit monetary policy signals in the money market through a single policy repo rate. 12 BIS central bankers’ speeches Evidence so far suggests a significant improvement in monetary policy transmission under the new operating framework. In order to reinforce this process, I make three suggestions.

First, there has been a swift transmission of policy rate at the short-end of money market, partly due to the prevalence of market liquidity in deficit mode. However, ensuring market liquidity in a deficit mode of desired level on a sustained basis is contingent on Reserve

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Bank's ability to effectively conduct OMOs and the market appetite for such operations. Hence, there is a need to develop the market micro-structure and further enhance secondary market transactions in government securities to facilitate smooth conduct of OMOs.

Second, the LAF is not the appropriate instrument for managing the liquidity of more enduring nature. As the system is expected to be in deficit, there is a need to develop term repo to minimize daily requirement of liquidity.

Third, notwithstanding significant advances in developing the market, the term structure in the money market is incomplete. It is, therefore, desirable to extend the yield curve beyond the overnight rate by developing a term-money market.

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