B.Com Honours 3rd Semester- IFS (Lesson 2): Money market

Syllabus: Functions and Instruments - Role of Central Bank – **Indian Money Market:** An overview-Call Money market- Treasury Bill market – Commercial Paper – Certificate of Deposit- **Concepts:** Repo- Reverse Repo – **Recent Trends in Indian Money Market**

Note: ***Only the highlighted portion has been covered under this lesson.***

What is a money market? As already noted, the money market is a **financial market that deals in short term financial instruments**, that is, the class of instruments with maturity period of up to one year.

Functions: The money market performs several important functions, as outlined below.

- It evens out the liquidity imbalances of an economy, that is, it evens out mismatches between short term fund surplus and short term fund deficit of the economy
- It is an important source of working capital
- It provides a platform for the monetary policy operations of the Central Bank of a country.
- The money market **provides interest rate signals for the economy**
- **It provides mush needed liquidity to the banking sector**

Instruments: When we discuss a market, we have to discuss the

(i) product (or class of products) transacted,
(ii) the participants,
(iii) the regulator, if any,
(iv) the price formation mechanism etc.

Therefore, we have started with the product (s), that is, the instruments transacted in the money market. However, in the course of our discussion, we shall be touching upon the other issues as well.

Important money market instruments

(i) **Call Money**
(ii) **Treasury Bills**
(iii) **Repos & Reverse Repos**
(iv) **Commercial Paper**
(v) **Certificates of deposits**
(vi) **Bills Discounted/rediscounted**
(vii) **Interest rate swaps, etc.** we shall discuss a few of these instruments in some detail later in the lesson.

Role of Central Bank

The Central Bank of a country (RBI in India) is the regulator of the money market. However, its role is not confined to that of a regulator only; it is also a player or a participant in the money market. In particular, the Central Bank

a) **Sets the rules in the money market**. For example, it lays down the eligibility conditions for the participants (in India, RBI stipulates who can issue a Commercial Paper or who can borrow/lend in the Call Money Market etc.). The Central Bank also lays down the transaction principles in many markets, like, say, in the Call Money market, the Treasury Bill market or the repo market in case of India.

b) **Acts as a referee in the money market**. In other words, it supervises whether all guidelines are being properly followed or not. If not, it has the power to impose penalty on a defaulting participant.

c) **Acts a player in the money market**. For example, it issues Treasury Bills in the market on behalf of the Government, it issues repos and reverse repos etc. thereby **controlling the liquidity in the economy in a direct manner**.

d) **Provides interest rate signals**. For example, the fixing of the repo rate and the reverse repo rate has a direct impact on the interest rate in the call money or other markets.

e) **Develops the money market.** One of the important tasks of the Central Bank is to develop the money market. By development, we mean

   (i) Adding **depth** (increasing the supply of and demand for various money market instruments) and **width** (increasing the types of money market instruments) in the market,

   (ii) Improving the transaction mechanism, like, say, building a robust electronic platform for e-transaction of instruments,

   (iii) Make the market more transparent,

   (iv) Make the market more accessible to the public, etc.

Indian Money Market – An Overview

The Indian money market can be divided into two parts- an organised money market and an unorganised money market. This dualism is present in all Indian markets. We briefly compare the two in a tabular form.

Basis for comparison	**Organised Money market**	**Unorganised money market**
Structure	There is a structure of operation in this market, which is well laid out by our regulator, the RBI.	There is no structure of operation in this market, so that it is governed by local custom, convention and economic forces.
Regulator	The Central Bank, that is the RBI c is the regulator	There is no regulator.
Rules and regulations	There is a strict set of rules as operational guidelines, applicable for the entire economy	There is virtually no regulation; only non-formal or verbal agreement on a one-to-one basis, the terms and conditions of which vary from place to place.
Players	RBI is at the same time a regulator, a player and a developer, while mainly FIs, commercial banks, insurance companies, NBFCs etc enter the market as players	Transactions are carried out in individual capacity without institutional involvement.
Interest	Interest rates are lower and integrated	Interest rates are much higher and not integrated

The organised money market is highly developed and modern. However, it is generally not accessed by the public. This market is the platform through which the RBI conducts its monetary policy, that is, controlling the liquidity in the economic system.

There are instruments of various maturity, liquidity and risk-profile. Interestingly, there is a large degree of correlation between the rates of all the diverse instruments. This shows the developed and mature status of the organised segment of the Indian money market.

Call Money Market

Call money is a money market instrument, which allows participants to **lend and borrow for the shortest possible maturity period – that is, one day,** or in other words, on an overnight basis. In general, **it is an inter-bank market**; though in India, it was once thrown open to several other organisations, including mutual funds.

However, now **only**

- commercial banks,
- cooperative banks and
- Primary Dealers are eligible to participate in the call money market (CMM).

The main purpose of having the CMM is to correct the very short run liquidity mismatch of the banking sector. We may discuss the basic features of the Indian CMM as follows:

The RBI has issued guidelines from time to time to ensure prudential operation of the CMM. There was a time when many institutions like LIC, NABARD, and GIC etc were allowed to participate in the CMM. However, from 2005 onward, only the commercial banks, cooperative banks and Primary Dealers are eligible to participate. **(Participants)**

The RBI has also set limits of lending and borrowing on each of the three types of participants. For example, commercial banks can borrow, during a reporting fortnight, a maximum of 100% of their capital fund (Tier I and Tier II) on a daily average basis, while they can lend a maximum of 25% of the said capital fund. **(Lending/Borrowing norms)**

The participants are free to choose interest rates, and thus, the call rates are completely market-determined. **(Interest determination)**

The Call Money transactions can be executed either on NDS-Call, a screen–based, negotiated, quote-driven electronic trading system managed by the Clearing Corporation of India (CCIL), or over the counter (OTC) through bilateral communication. **(Trading method)**

Dealings in Call executed on the NDS-Call, do not require separate reporting. However, it is mandatory that all the OTC deals be reported over the reporting platform. **(Reporting requirement)**