B.Com. Hons. in Accounting
2nd Semester
BCOMHFINGE201: Money Market

Unit-2: Introduction to Money Market

Compiled By
Sukumar Paitandi
Dept. of Commerce
Raniganj Girls' College

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. It is the market in which financial institutions, mainly banks lend and borrow money. In a money market, funds can be borrowed for a short period varying from a day, a week, a month or 3 to 6 months, sometimes up to one year.
In other words, "it is a network of market that are grouped together because they deal in financial instruments that have a similar function in the economy and are to some degree substitutes from the point of view of holders."
Thus the money market consists of call and notice market, commercial bills market; commercial paper market, treasury bills market, inter-bank market and certificates of deposit market. All these markets are closely interrelated so as to make the money market. It is a wholesale market where large numbers of financial assets or instruments are traded.

Features of Money Market:

The following are the general features of a money market:

1. It is market purely for short-term funds or financial assets called near money.
2. It deals with financial assets having a maturity period up to one year only.
3. It deals with only those assets which can be converted into cash readily without loss and with minimum transaction cost.
4. Generally transactions take place through phone i.e., oral communication. Relevant documents and written communications can be exchanged subsequently. There is no formal place like stock exchange as in the case of a capital market.
5. Transactions have to be conducted without the help of brokers.
6. The components of a money market are the Central Bank, Commercial Banks, Non-banking financial companies, discount houses and acceptance house. Commercial banks generally play a dominant in this market.

Objectives of Money Market:

The objectives of the money market are to implement the monetary policy of the country. Monetary policy has three main objectives — growth, equity and price stability. The objective of the monetary policy in the first decade of plan-ning was the revival of traditional weapons of mon-etary control.

In addition the monetary policy takes care of promotional aspects such as:
(i) Monetary integration of the country,
(ii) Directing credit flow according to policy priorities,
(iii) Assisting in mobilisation of the savings of the community,
(iv) Promotion of capital formation and
(v) Maintain an appropriate structure of relative prices and demand containment.

Importance of Money Market:

The money market meets the short-term re-quirements of the borrowers and provides liquidity to the lenders. These markets therefore provide information for monetary policy formulation and management.

The Reserve Bank of India occupies a strategic position in the money market by changing the level of liquidity in the economy through open market operations and by regulating the access of the banks to its accommodation.

It is for this reason that development of a money market itself becomes an important monetary regulation measure. Money markets are not merely a channel for transferring short-term funds from savers to investors, but also provide information on the underlying conditions of supply and demand.

More importantly, they are essential for moving from quantity based to market-based instruments of monetary management. There is, therefore, an urgent need for deepening and broad-basing the market for debt instruments and Govt. dated securities. Institutional support should be provided wher-ever needed.

Functions of a Money Market:

A money market performs a number of functions in an economy.

1. Provides Funds:

It provides short-term funds to the public and private institutions needing such financing for their working capital requirements. It is done by discounting trade bills through commercial banks, discount houses, brokers and acceptance houses. Thus the money market helps the development of commerce, industry and trade within and outside the country.

2. Use of Surplus Funds:

It provides an opportunity to banks and other institutions to use their surplus funds profitably for a short period. These institutions include not only commercial banks and other financial institutions but also large non-financial business corporations, states and local governments.

3. No Need to Borrow from Banks:

The existence of a developed money market removes the necessity of borrowing by the commercial banks from the central bank. If the former find their reserves short of cash requirements they can call in some of their loans from the money market. The commercial banks prefer to recall their loans rather than borrow from the central banks at a higher rate of interests.

4. Helps Government:

The money market helps the government in borrowing short-term funds at low interest rates on the basis of treasury bills. On the other hand, if the government were to issue paper money or borrow from the central bank. It would lead to inflationary pressures in the economy.

5. Helps in Monetary Policy:

A well developed money market helps in the successful implementation of the monetary policies of the central bank. It is through the money market that the central banks are in a position to control the banking .system and thereby influence commerce and industry.

6. Helps in Financial Mobility:

By facilitating the transfer for funds from one sector to another, the money market helps in financial mobility. Mobility in the flow of funds is essential for the development of commerce and industry in an economy.

7. Promotes Liquidity and Safety:

One of the important functions of the money market is that it promotes liquidity and safety of financial assets. It thus encourages savings and investments.

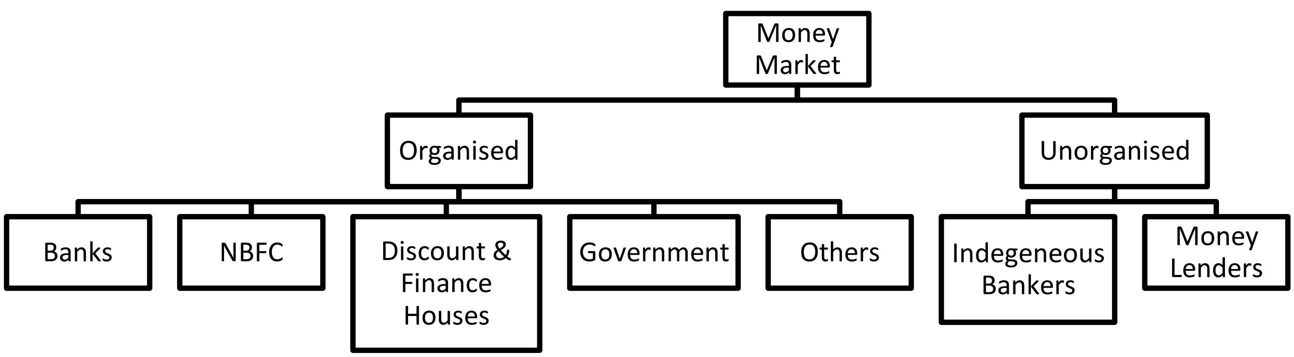
8. Equilibrium between Demand and Supply of Funds:

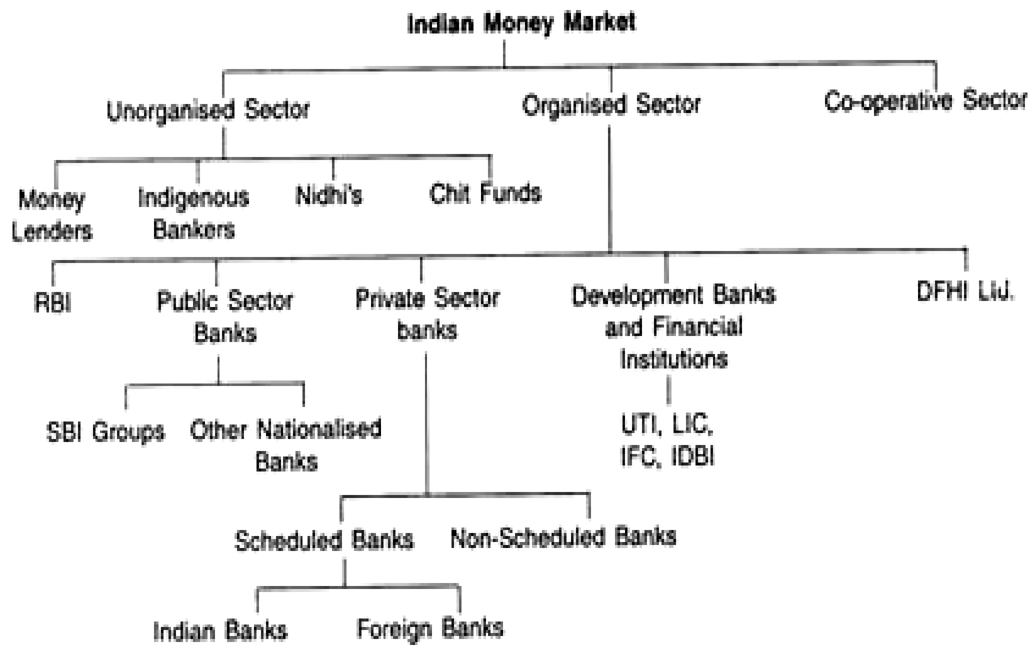
The money market brings equilibrium between the demand and supply of loanable funds. This it does by allocating saving into investment channels. In this way, it also helps in rational allocation of resources.

9. Economy in Use of Cash:

As the money market deals in near-money assets and not money proper, it helps in economising the use of cash. It thus provides a convenient and safe way of transferring funds from one place to another, thereby immensely helping commerce and industry.

Classification of Money Market:





Indian Money Market: Organised and Unorganised Sectors

The organised sector of the money market con-sists of the Reserve Bank of India, commercial banks, companies lending money, financial inter-mediaries such as the Life Insurance, Credit and Investments Corporation of India, Unit Trust of India, Land Mortgage Banks, Cooperative Banks, Insurance Companies etc. and call loan brokers, and stock brokers.

The unorganised sector of the money market is largely made up of indigenous bankers, money lenders, traders, commission agents etc., some of whom combine money lending with trade and other activities.

Generally speaking, these two sec-tors of the Indian money market — those institu-tions which come directly or indirectly under the broad regulations of the Reserve Bank constitute the organised sector, while the others which fall completely outside the purview of the central bank-ing regulations, make up the unorganised sector.

The organised sector is mainly composed of the commercial banks, cooperative banks and dis-count houses, acceptance houses and land mort-gage banks. The unorganised sector is largely outside the control of the Central Bank and is characterised by lack of uniformity in their business dealings. In India, the indigenous bankers and money lend-ers, traders, are important segment of unorgan-ised money market.

Organised Money Market vs. Unorganised Money Market

The Indian money market is divided into two parts, namely; the organized and the unorganized money markets. Interest rates are different in both the markets and there is no relationship whatsoever between the two markets. The unorganized sector consists of indigenous bankers, money lenders and unregulated non-bank financial intermediaries such as finance companies, chit funds and nidhis. Farmers, artisans and other small time producers and traders borrow money from the unorganized money market.

The interest rate charged is highly exploitative and therefore entrapping the borrowers into a debt trap. The organized money market is the formal market for money regulated by the central bank with commercial banks being the main players. Foreign banks, co-operative banks, Discount and Finance House of India, finance companies, provident funds, Securities Trading Corporation of India, Public Sector Undertakings and mutual funds are the other institutions which operate in the formal Indian money market. The Reserve Bank of India is the monetary authority controlling the formal money market.

The formal Indian money market is well organized and integrated. Mumbai, Kolkata, Delhi, Chennai, Ahmedabad and Bangalore are the main centers of the organized sector. Out of these, the Mumbai money market is the largest.

The Organized Sector of the Indian Money Market

The components of the organized Indian Money Market are as follows:

1. The Call Money Market.
2. The Treasury Bill Market.
3. The Repo Market.
4. The Commercial Bill Market.
5. The Certificate of Deposit Market.
6. The Commercial Paper Market.
7. Money Market Mutual Funds.

Unorganized Sector of the Indian Money Market : The constituents of the unorganized sector of the Indian Money Market are as follows:

1. Non-Banking Financial Companies (NBFCs): These companies assume various forms. Some of the prominent forms of NBFCs are loan/finance companies, chit funds and nidhis. Finance or loan companies are spread across the country.
2. Indigenous Bankers. Individual Bankers are individuals or private firms that receive deposits and give loans. These bankers have been engaged in the banking business from ancient times.
3. Money Lenders. They are three types of money lenders. They are: professional money lenders, itinerant money lenders like pathans and Kabulis and non-professional money lenders. Money lenders do not receive deposits.

The unorganized money market survives and flourishes in India because of two important factors. They are:

(1) a large amount of unaccounted wealth and income floats in the country and the creamy section of the black economy both on the lenders and the depositors side operate in this market, and

(2) the poor who cannot access the organized market for want of securities look at the unorganized market as the lender of last resort. Several legislative measures have been passed to prevent exploitation of the borrowers by moneylenders but these measures have remained on paper. Exploitation of the poor borrowers will come to an end only if micro-finance system covers the entire population of poor in the country.

Difference between Organised Money Market and Unorganised Money Market

Organised Money Market	Unorganised Money Market
It is the formal market	It is the informal market
Money regulated by the central bank with commercial banks being the main players	No Regulators
It consists of the Call Money Market, the Treasury Bill Market, the Repo Market, Money Market Mutual Funds, etc.	It consists of indigenous bankers, money lenders and unregulated non-bank financial intermediaries such as finance companies, chit funds and nidhis.

Producers, traders, etc borrow money from the this money market	Farmers, artisans and other small time producers and traders borrow money from this money market
It is well organized and integrated.	It is not well organized and integrated.

Features of a Developed Money Market:

The developed money market is a well organised market which has the following main features:

1. A Central Bank:

A developed money market has central banks at the top which is the most powerful authority in monetary and banking matter. I controls, regulates and guides the entire money market. It provides liquidity to the money market, as it is the lender of the last resort to the various constituents of the money market.

2. Organised Banking System:

An organised and integrated banking system is the second feature of a developed money market. In fact, it is the pivot around which the whole money market revolves. It is the commercial banks which supply short-term loans, and discount bills of exchange. They form an important link between the borrowers, brokers, discount houses and acceptance houses and the central bank in the money market.

3. Specialised Sub-Markets:

A developed money market consists of a number of specialised sub-markets dealing in various types of credit instruments. There is the call loan market, the bill market, the Treasury bill market, the collateral loan market and the acceptance market, and the foreign exchange market. The larger the number of sub-markets, the more developed is the money market. But the mere number of sub-markets is not enough. What is required is that the various sub-markets should have a number of dealers in each market and the sub-markets should be properly integrated with each other.

4. Existence of Large Near-Money Assets:

A developed money market has a large number of near-money assets of various types such a bills of exchange, promissory notes, treasury bills, securities, bonds, etc. The larger the number of near-money assets, the more developed is the money market.

5. Integrated Interest-Rate Structure:

Another important characteristic of a developed money market is that it has an integrated interest-rate structure. The interest rates prevailing in the various sub-markets are integrated to each other. A change in the bank rate leads to proportional changes in the interest rate prevailing in the sub-markets.

6. Adequate Financial Resources:

A developed money market has easy access to financial sources from both within and outside the country. In fact, such a market attracts adequate funds from both sources, as is the case with the London Money Market.

7. Remittance Facilities:

A developed money market provides cash and cheap emittance facilities for transferring funds from one market to the other. The London Money Market provides such remittance facilities throughout the world.

8. Miscellaneous Factors:

Besides the above noted features, a developed money market is highly influenced by such factors as restrictions on international transactions, crisis, boom, depression, war, political instability, etc.

Characteristics of Indian Money Market:

The main features of Indian Money Market are as follows:

1. Dichotomy:

The Indian Money market is divided between two sectors, namely organised sector and unorganised sector. There is very little cooperation and contact between them. Consequently the rate of interest in both the markets varies widely.

2. Seasonal Variations:

Considering the demand for funds, there are two seasons, the busy season and slack season. The busy season covers the period from November to April when agricultural products come into the market.

There is great demand for funds during this period. The slack season covers the period between May and October. The funds begin to be repaid and there is substantial fall in the demand for funds.

3. Inter-Call Money Market:

The core of the Indian money market is the inter-bank call money market. It is the most sensitive sector of the money market.

4. Predominant Place of Government Securities:

In the Indian money market, the predominant place is enjoyed by government and semi government securities.

5. Absence of Acceptance and Discount Houses:

There is almost complete absence of acceptance and discount houses in the Indian money market. This is due to the underdeveloped bill market in India.

6. Isolation from Foreign Money Market:

The Indian money market is isolated from foreign markets. There is hardly any movement of funds between Indian Money Market and foreign markets.

7. Variety of Financial Institutions:

The Indian market is characterised by the presence of a large number of financial institutions such as non-banking financial intermediaries, cooperative banks, Export-Import banks. They cater to the financial needs of different sectors.

Deficiencies of Indian Money Market:

The Indian money market has many distinctive characteristics but it also suffers from various defects. Following are some and defects:

(1) Lack of Adequate Integration: There is lack of adequate integration in the Indian money market. The organised and the unorganised sector of Indian money market are totally separate from each other and they have independent financial operations of their own. Therefore, activities of one sector have no impact on the activities of the other sector. It is very difficult to establish a national money market under such a background.

(2) Shortage of Funds: Another important feature of Indian money market is the shortage of funds. Therefore, the demand for loanable funds in the money market is much higher than that of its supply. This shortage of fund is mostly resulted from:

(i) Small capacity to save arising out of low per capita income;

(ii) Inadequate banking network and poor banking habit of the people;
(iii) Absence of adequate and diversified investment opportunities and finally, the emergence of strong parallel economy having a huge magnitude of black money.

In recent years, the development of rural banking structure, with the opening rural branches of commercial banks and with the expansion of Co-operative banks, has improved the fund position of the Indian money market, to some extent.

(3) Lack of Adequate Banking Facilities: Indian money market is also characterised by lack of adequate banking facilities. Rural banking network in the country is still inadequate. Population per bank office in India was 12,000 persons in 1993 as compared to that of only 1,400 persons in USA. In the rural areas, a substantial number of population, having small saving potential, have no access to facilities.

Under such a system, a huge amount of small savings are not mobilised which needs to be mobilised for its productive uses through the expansion of banking network.

(4) Lack of Rational Interest Rate Structure: There is lack of rational interest structure which is mostly resulted from lack of co-ordination among different banking institutions. Recently, there is some improvement in this regard, particularly after the introduction of standardisation of interest rates by the RBI for its rationalisation.

However, the present system of administered interest rates is suffering from the defects like:

(i) Too many concessional rates of interest;
(ii) Comparatively low yield on government securities, and
(iii) Improper lending and deposit rates fixed by the commercial banks.

(5) Absence of Organised Bill Market: There is absence of organised bill market in India although the commercial banks purchase and discount both inland and foreign bills to a limited extent. Although, the RBI has introduced its limited bill market under its scheme of 1952 and 1970, but the same scheme has failed to popularize the bill finance in India.

(6) Existence of Unorganised Money Market: Another important feature of Indian money market is the existence of its unorganised character, where one of its segments is constituted by the indigenous bankers and moneylenders. This unorganised segment in completely separated from the organised segment of the money market.

Although the RBI has tried to bring the indigenous bankers under its direct control yet all the attempts have failed. Thus, as the indigenous bankers remained outside the organised money market, therefore, RBI’s control over the money market is quite limited.

(7) Seasonal Stringency of Money and Fluctuations in Interest Rates: Money market is not having sufficient elasticity thus it creates seasonal stringency of funds leading to a rise in the rate of interest. But in the rainy and slack season the demand for fund slumps down leading to a automatic fall in the rate of interest. Such regular fluctuations in interest rates are not at all conducive to developmental activities of the country.

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