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The Role of Money Market in Indian Economy (Growth)

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ABSTRACT

As money became a commodity, the money market became a component of the financial markets for assets involved in short-term borrowing, lending, buying and selling with original maturities of one year or less. Trading in money markets is done over the counter and is wholesale. There are several money market instruments, including treasury bills, commercial paper, bankers' acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements, federal funds, and short-lived mortgage- and asset-backed securities. The instruments bear differing maturities, currencies, credit risks, and structure and thus may be used to distribute exposure Most financial institutions are highly regulated by government. The definition of money for money market purposes is not confined to bank notes but includes a range of assets that can be turned into cash at short notice, such as short-term government securities, bills of exchange, and bankers' acceptances .This paper discuss only the role of money market useful for making growth of Indian Economy

Keywords: Financial sector, financial innovation, financial markets and money market, Financial Institution

Objectives of the Study:

1. To study the Role of Money market in India
2. To know the importance of Money market in India
3. To study the Growth Money Market In india

Methodology:

This paper is conceptual in nature. Data collection was achieved by online websites &the date is filtered to improve the quality of paper.

I. INTRODUCTION

Financial openness is often regarded as providing important potential benefits. Access to money markets expands investors' opportunities for a potential for achieving higher risk-adjusted rates of return. It also allows countries to borrow to smooth consumption in the face of adverse shocks, the potential growth and welfare gains resulting from such international risk sharing can be large (Obstfeld, 1994). It has also been argued that by increasing the rewards of good policies and the penalties for bad policies, free flow of capital across borders may induce countries to follow more disciplined macroeconomic policies that translate into greater macroeconomic stability. An increasingly common argument in favour of financial openness is that it may increase the depth and breadth of domestic financial markets and lead to an increase in financial intermediation process by lowering costs and "excessive" profits associated with monopolistic or cartelized markets, thereby lowering the cost of investment and improving resource allocation.

Definition of 'Money Market'

Definition: Money market basically refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded. Money market has become a component of the financial market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers. Over-the-counter trading is done in the money market and it is a wholesale process. It is used by the participants as a way of borrowing and lending for the short term. Description: Money market consists of negotiable instruments such as treasury bills, commercial papers. and certificates of deposit. It is used by many participants, including companies, to raise funds by selling commercial papers in the market. Money market is considered a safe place to invest due to the high liquidity of securities.

II. LITERATURE REVIEW

The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods, typically up to twelve months. Money market trades in short-term financial instruments commonly called "paper". This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity.

The core of the money market consists of interbank lending—banks borrowing and lending to each other using commercial paper, repurchase agreements and similar instruments. These instruments are often benchmarked to (i.e., priced by reference to) the London Interbank Offered Rate (LIBOR) for the appropriate term and currency.

Finance companies typically fund themselves by issuing large amounts of asset-backed commercial paper (ABCP), which is secured by the pledge of eligible assets into an ABCP conduit. Examples of eligible assets include auto loans, credit card receivables, residential/commercial mortgage loans, mortgage-backed securities and similar financial assets. Some large corporations with strong credit ratings, such as General Electric, issue commercial paper on their own credit. Other large corporations arrange for banks to issue commercial paper on their behalf.

In the United States, federal, state and local governments all issue paper to meet funding needs. States and local governments issue municipal paper, while the U.S. Treasury issues Treasury bills to fund the U.S. public debt:

- Trading companies often purchase bankers' acceptances to tender for payment to overseas suppliers.
- Retail and institutional money market funds
- Banks
- Central banks
- Cash management programs
- Merchant banks

Money markets serve five functions—to finance trade, finance industry, invest profitably, enhance commercial banks' self-sufficiency, and lubricate central bank policies.[3][4]

Financing trade
The money market plays crucial role in financing domestic and international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

Financing industry

The money market contributes to the growth of industries in two ways:

- They help industries secure short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
- Industries generally need long-term loans, which are provided in the capital market. However, the capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

Profitable investment
The Money Market enables the commercial banks to use their excess reserves in profitable investment. The main objective of the commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of the depositors. In the money market, the excess reserves of the commercial banks are invested in near-money assets (e.g., short-term bills of exchange), which are easily converted into cash. Thus, commercial banks earn profits without sacrificing liquidity.

Self-sufficiency of commercial bank
Developed money markets help the commercial banks to become self-sufficient. In the situation of emergency, when the commercial banks have scarcity of funds, they need not approach the central bank and borrow at a higher interest rate. On the other hand, they can meet their requirements by recalling their old short-run loans from the money market.

Help to central bank
Though the central bank can function and influence the banking system in the absence of a money market, the existence of a developed money market smooths the functioning and increases the efficiency of the central bank.

Money markets help central banks in two ways:

- Short-run interest rates serve as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,
- Sensitive and integrated money markets help the central bank secure quick and widespread influence on the sub-markets, thus facilitating effective policy implementation

According to SaurabhGhosh and Narayan Chandra Pradhan (2009)
The authors have tried to understand the determinants of WADR (weighted average discount rate) and how these determinants have affected their movement over the past 5 years after adjusting for seasonal fluctuation. The real and financial variables considered for the study were: - Index of industrial production (IIP), Amount of CP issued, Cut-off yield 364 days, Call/Notice money, Sensex, Indian Rupees – U.S. Dollar exchange rate & bank credit. A close movement and dependency was found out between WADR and the call rate & the 364 day treasury bill yield. Although initially there wasn't much co-movement between WADR and the BSE Sensex, co-movements were noticeable after December 2005.The empirical results indicate that there has been an increase in the average monthly issuance, WADR and volatility of WADR over the years. However, around 80% of the commercial paper issued by companies over the last five years was from ‘Prime-rated' companies.

According to Matthias Kahl, Anil Shivdasani&Yihui Wang (2008)
Firms access commercial paper market to enhance their financial flexibility. Firms use it to fund investment when attractive projects arise and they have insufficient internal funds. Another way in which commercial paper may be used to increase a firm's financial flexibility is as bridge financing. They argue that commercial paper borrowing in positively correlated with investment expenditures and negatively correlated with cash holdings.

According to PengjieGao and Hayong Yun± (2009)
The collapse of Lehman brothers was followed by a virtual closing of the commercial papers market, followed by which a number of firms drew excessively on their remaining lines of credit out of fear that weakened banks would reduce their loan commitments. Aggregate commercial paper borrowing declined 15% after the collapse of Lehman brothers, but the effect was concentrated among firms with high default risk. High risk borrowers that were negatively impacted by the decline in the commercial paper market after Lehman's default substituted commercial paper with lines of credit. Low risk borrowers remained as they were.

According to Charles W. Calomiris, Charles P. Himmelberg& Paul Wachtel (1994)
The authors arrived at three conclusions. Firstly, there is a flight to quality during a downturn. Firms with strong balance sheets exploit this demand to reduce their cost of short-term borrowing. Secondly, firms in strong financial condition issue commercial paper during downturns in order to extend credit to other firms which may include customers of the firm. As the economy weakens, customers pay their bills more slowly and firms may extend more trade credit as a means of financing their customers' short-term credit needs. There is evidence that commercial paper is used to finance trade credit. Finally, increased commercial paper issuance is used to finance inventories.

Further, they established links between growth of commercial paper in relationship between the paper market and the commercial bank portfolios. At various times the growth of the commercial paper market was attributed to –

(i.) Banks with weak loan demand that were searching for an alternative asset.
(ii.) Regulatory constraints that made bank deposits unattractive.
(iii.) Market conditions that made bank loans relatively expensive.

According to John P. Judd (1979)
The researcher argues that commercial paper market has replaced the banking sector as the primary source of short-term funds for large financially sound nonfinancial firms. Banks can compete effectively only if the value of the intermediate services that they provide to the lenders/borrowers is greater than the spread between the lending and borrowing rates that they must charge to cover the costs of doing business and absorbing risk. However, it was found that the value from the intermediate services were relatively small and hence the switch over to commercial paper.

According to PuShen (2003)
Before the current drop in commercial paper outstanding there was a past occurrence in 2002 when the market for nonfinancial paper declined rapidly. The author tries to understand the factors that led to the unusual decline. To achieve this he considered the factors that could have reduced the supply of credit as well as factors that could have reduced the demand in the commercial paper market. On the basis of this analysis, a conclusion was reached that both

demand and supply contributed to the decline. Supply in this context means willingness of the investors' to participate in the market. Willingness can be reduced by two factors – Actual or perceived deterioration of the creditworthiness of borrowers and general reduction in investors' tolerance for risk. On the demand side, two factors reduce the need for corporations to borrow in the commercial paper market. One factor is decline in inventories which reduces companies' short-term financing needs. The other factor is a switch by firms from borrowing short-term in the commercial paper market to borrowing longer in the bond market.

According to Dan Covitz& Chris Downing (2002)
A model is created to explain the relationship between short term and long term yield spreads. Short term spreads cannot be explained by insolvency model because of large spread. Many a times short and long term spreads are negatively correlated. Their explanation for observed risk spreads rests on a distinction between the fixed and liquid assets of a firm. A simple model was proposed in which a firm with a low level of liquid assets may be forced to turn to outside sources of funds to meet its short-term obligations. Funds raised from outside can bring in delay in payments to creditors, which can affect the short term creditors more than long term creditors. Variety of insolvency-risk and liquidity-risk proxies were used and was found that liquidity risk help explain short-term spreads during periods of market stress, but explains very little about long-term spreads. Their empirical findings indicated that while liquidity is an important determinant, the credit risk is the dominant determinant of Commercial Paper credit spread.

III. ROLE OF MONEY MARKET IN INDIA

Financial assets of long-term maturity is very much the domain of the investors of the capital market where these long-term securities are traded. ‘Short-term’ in the Indian context means generally a period up to one year. The term ‘close substitutes for money’ means any financial asset which can be quickly converted into money with minimum transaction/conversion cost.

IV. PRODUCING INFORMATION AND ALLOCATING CAPITAL

The information production role of financial systems is explored by Ramakrishnan and Thakor (1984), Bhattacharya and P fleiderer (1985), Boyd and Prescott (1986), and Allen (1990). They develop models where financial intermediaries arise to produce information and sell this information to savers. Financial intermediaries can improve the ex ante assessment of investment opportunities with positive ramifications on resource allocation by economizing on information acquisition costs.

V. RISK SHARING

One of the most important functions of a financial system is to achieve an optimal allocation of risk. There are many studies directly analyzing the interaction of the risk sharing role of financial systems and economic growth. These theoretical analyses clarify the conditions under which financial development that facilitates risk sharing promotes economic growth and welfare.

VI. LIQUIDITY

Money market funds provide valuable liquidity by investing in commercial paper, municipal securities and repurchase agreements: Money market funds are significant participants in the commercial paper, municipal securities and repurchase agreement (or repo) markets.

VII. DIVERSIFICATION

For both individual and institutional investors, money market mutual funds provide a commercially attractive alternative to bank deposits. Money market funds offer greater investment diversification, are less susceptible to collapse than banks and offer investors greater disclosure on the nature of their investments and the underlying assets than traditional bank deposits. For the financial system generally, money market mutual funds reduce

Encouragements To Saving And Investment
Money market has encouraged investors to save which results in encouragement to investment in the economy. the savings and investment equilibrium of demand and supply of loanable funds helps in the allocation of resources.

Controls The Price Line In Economy
Inflation is one of the severe economic problems that all the developing economies have to face every now and then. Cyclical fluctuations do influence the price level differently depending upon the demand and supply situation at the given point of time. Money market rates play a main role in controlling the price line.

Helps In Correcting The Imbalances In Economy.
Financial policy on the other hand, has longer term perspective and aims at correcting the imbalances in the economy. Credit policy and the financial policy both balance each other to achieve the long term goals strong-minded by the government.

Regulates The Flow Of Credit And Credit Rates
Money markets are one of the most significant mechanisms of any developing financial system. In its place of just ensure that the money market in India regulate the flow of credit and credit rates, this instrument has emerge as one of the significant policy tools with the government and the RBI to control the financial policy, money supply, credit creation and control, inflation rate and overall economic policy of the State.

Functions of Money Market:
1. To maintain monetary balance between demand and supply of short term monetary transactions.
2. Money market plays a very important role of making funds available to many units or entities engaged in diversified field of activities be it agriculture, industry, trade, commerce or any other business.
3. By providing funds to developing sectors it helps in growth of economy also.
4. Another important feature that money market provides is discounting of bills of exchange which facilitates growth of trade.
5. No doubt it provides a base for the implementation of monetary policy also.
6. The money market provides opportunity for short term investments, which provide for short term savings.

VIII. IMPORTANCE OF MONEY MARKET

A well-developed money market is essential for a modern economy. Though, historically, money market has developed as a result of industrial and commercial progress, it also has important role to play in the process of industrialization and economic development of a country. Importance of a developed money market and its various functions are discussed below:

1. Financing Trade:
Money Market plays crucial role in financing both internal as well as international trade. Commercial finance is made available to the traders through bills of exchange, which are discounted by the bill market. The acceptance houses and discount markets help in financing foreign trade.

2. Financing Industry:
Money market contributes to the growth of industries in two ways:
(a) Money market helps the industries in securing short-term loans to meet their working capital requirements through the system of finance bills, commercial papers, etc.
(b) Industries generally need long-term loans, which are provided in the capital market. However, capital market depends upon the nature of and the conditions in the money market. The short-term interest rates of the money market influence the long-term interest rates of the capital market. Thus, money market indirectly helps the industries through its link with and influence on long-term capital market.

3. Profitable Investment:
Money market enables the commercial banks to use their excess reserves in profitable investment. The main objective of the commercial banks is to earn income from its reserves as well as maintain liquidity to meet the uncertain cash demand of the depositors. In the money market, the excess reserves of the commercial banks are invested in near-money assets (e.g. short-term bills of exchange) which are highly liquid and can be easily converted into cash. Thus, the commercial banks earn profits without losing liquidity.

4. Self-Sufficiency of Commercial Bank:
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5. Help to Central Bank:
Though the central bank can function and influence the banking system in the absence of a money market, the existence of a developed money market smoothens the functioning and increases the efficiency of the central bank.
Money market helps the central bank in two ways:
(a) The short-run interest rates of the money market serves as an indicator of the monetary and banking conditions in the country and, in this way, guide the central bank to adopt an appropriate banking policy,
(b) The sensitive and integrated money market helps the central bank to secure quick and widespread influence on the sub-markets, and thus achieve effective implementation of its policy

IX. 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 age in India has witnessed marvelous increase of the Indian money markets. Banks and other financial institutions have been able to meet the high opportunity of short term financial support of important sectors like the industry, services and agriculture. It performs under the regulation and control of the Reserve Bank of India (RBI). The Indian money markets have also exhibit the required maturity and flexibility over the past two decades. Decision of the government to permit the private sector banks to operate has provided much needed healthy competition in the money markets resulting in fair amount of improvement in their performance.

X. 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.

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.

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.

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.

Structure Of The Money Market In India
In view of the rapid changes on account of financial deregulation and global financial markets integration, central banks in several countries have striven to develop and deepen the money markets by enlarging the ambit of instruments5 and participants so as to improve the transmission channels of monetary policy.
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Call Money Market: It an important sub market of the Indian money market.It is also known as money at call and money at short notice. It is also called inter bank loan market. In this market money is demanded for extremely short period. The duration of such transactions is from few hours to 14 days.

Recent Developments In Call Money Market
Banks and primary dealers in government securities may soon have more flexibility in borrowing and lending in the call money market. The Reserve Bank of India said that banks may be allowed to borrow and lend in the inter bank call money market based on their assets and liability match rather than prudential limits.

Commercial Bill Market: It is a market for the short term, self liquidating and negotiable money market instrument. Commercial bills are used to finance the movement and storage of agriculture and industrial goods in domestic and foreign markets. The commercial bill market in India is still underdeveloped.

Treasury Bill Market: This is a market for sale and purchase of short termgovernment securities. These securities are called as Treasury Bills which are promissory notes or financial bills issued by the RBI on behalf of the Government of India. There are two types of treasury bills. (i) Ordinary or Regular Treasury Bills and (ii) Ad Hoc Treasury Bills. The maturity period of these securities range from as low as 14 days to as high as 364 days. They have become very popular recently due to high level of safety involved in them

CONCLUSION

The money market is a key component of the financial system as it is the fulcrum of monetary operations conducted by the central bank in its pursuit of monetary policy objectives.. The money market performs three broad functions. Firstly, it provides an equilibrating mechanism for demand and supply of short-term funds. Secondly, it enables borrowers and lenders of short-term funds to fulfil their borrowing and investment requirements at an efficient market clearing price. Three, it provides an avenue for central bank intervention in influencing both quantum and cost of liquidity in the financial system, thereby transmitting monetary policy impulses to the real economy.

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