Role and Growth of Money Market in Indian Economy: An Analysis

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Abstract

Money Market is an institutional arrangement which makes possible the raising of short term finance in a common meeting ground where prospective lenders and borrowers meet. The role of the money market in the overall financial system is by far the most important as it fulfils the twin objectives of evening out short term needs and acting as the market place for the Central Bank of the country (RBI) to control the monetary policy. The presence of an active and vibrant money market is an essential pre-requisite for the growth and development of the economy The money market in India existed in an underdeveloped form until the 1980s with the unorganized sector dominating transactions. Very few institutional instruments were permitted to operate. Secondary market was virtually non-existent.

Introduction

Money Market:

The money market refers to trading in very short-term debt investments. At the wholesale level, it involves large-volume trades between institutions and traders. At the retail level, it includes money market mutual funds bought by individual investors and money market accounts opened by bank customers. With the acceptance and implementation of many of the recommendations of the Chakravarty Committee in 1985 and the Vaghul Committee in 1987 the growth in the money market picked up momentum. Since then, the Indian money market has shown a fair amount of resilience with innovations becoming the order of the day. New instruments have evolved and new institutions have been established to impart depth to the system. A Discount and Finance House of India (DFHI) was set up in 1988 as a Reserve Bank of India subsidiary with participation from other money market institutions to facilitate smoothening of short-term liquidity imbalances and to impart greater flexibility in the money market. In 1992, the conditions in the money market of India can be described as one of the developing, if not developed, money markets of the world. The role played by the Call Money market in providing a cushion to the banks and financial institutions in meeting the statutory requirements as well as an avenue to the surplus funds with banks and financial institutions is discussed below. Call Money market is a system where short term finance can be raised in a common meeting ground where prospective lenders and borrowers meet. The inter-bank call money market is an example of organised money market in India. Banks have to maintain the Statutory Cash Reserve Ratio (CRR) with the RBI and they need cash for meeting these requirements.

Structure of the Money Market in India

In the Indian money market RBI occupies a key role. It is the nerve centre of the monetary system of our country. It is the leader of the Indian money market. The Indian money market is highly disintegrated and unorganized. The Indian money market can be divided into two sectors - unorganized and organised. In between these two, there exists the co-operative sector. It can be included in the organised sector.

The organised sector comprises of RBI, SBI group of banks, public sector banks, private sector banks, development banks and other financial institutions. The unorganised sector comprises of indigenous bankers, money lenders, chit funds etc. These are outside the control of RBI. This is the reason why Indian money market remains underdeveloped.

Role of Money Market in Economy

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.

Organized financial markets have existed in India for more than a century. Today, markets of varying maturity exist in equity, debt, commodities and foreign exchange. There are 25 stock markets all over the country, the most important of which, are the Bombay Stock Exchange and the National Stock Exchange. The rupee has been convertible on the current account since 1992.

India Financial Market helps in promoting the savings of the economy - helping to adopt an effective channel to transmit various financial policies. The Indian financial sector is well- developed, competitive, efficient and integrated to face all shocks. In the India financial market there are various types of financial products whose prices are determined by the numerous buyers and sellers in the market. The other determinant factor of the prices of the financial products is the market forces of demand and supply.

The India money market is a monetary system that involves the lending and borrowing of short-term funds. India money market has seen exponential growth just after the globalization initiative in 1992. It has been observed that financial institutions do employ money market instruments for financing short-term monetary requirements of various sectors such as agriculture, finance and manufacturing. The performance of the India money market has been outstanding in the past 20 years.

Central bank of the country - the Reserve Bank of India (RBI) has always been playing the major role in regulating and controlling the India money market. The intervention of RBI is varied - curbing crisis situations by reducing the cash reserve ratio (CRR) or infusing more money in the economy.

1. 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. As Schumpeter (1912) argued, financial systems can enhance growth by spurring technological innovation by identifying and funding entrepreneurs with the best chance of successfully implementing innovative procedures

2. 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. Quite often in these studies, however, authors focus on either markets or intermediaries, or a comparison of the two extreme cases where every financing is conducted by either markets or intermediaries.

3. 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. Money market funds hold almost 40% of all outstanding commercial paper, which is now the primary source for short-term funding for corporations, who issue commercial paper as a lower-cost alternative to short-term bank loans. The repo market is an important means by which the Federal Reserve conducts monetary policy and provides daily liquidity to global financial institutions.

4. 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.

5. 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.

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. 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.

Features or Defects of the Indian Money Market

1. **Existence of unorganised segment**: The most important defect of the Indian money market is the existence of unorganised segment. The unorganised segment comprises of indigenous bankers, moneylenders etc. This unorganised sector does not follow the rules and regulations of the RBI. Besides, a higher rate of interest prevails in the unorganised market.
2. **Lack of integration:** Another important drawback of the Indian money market is that the money market is divided into different sections. Unfortunately these sections are loosely connected to each other. There is no co-ordination between the organised and unorganised sectors. With the setting up of the RBI and the passing of the Banking Regulations Act, the conditions have improved.
3. **Disparities in interest rates:** Interest rates in different money markets and in different segments of money market still differ. Too many interest rates are prevailing in the market. For

example, borrowing rates of Govt. lending rate of commercial banks, the rates of co-operative banks and rates of financial institutions. This disparity in interest rates is due to lack of mobility of funds from one segment to another.

4. **Seasonal diversity of money market**: The demand for money in Indian money market is of seasonal in nature. During the busy season from November to June, money is needed for financing the marketing of agricultural products, seasonal industries such as sugar, jaguar, etc. From July to October the demand for money is low. As a result, the money rates fluctuate from one period to another.
5. **Absence of bill market:** The bill market in India is not well developed. There is a great paucity of sound commercial bills of exchange in our country. As a matter of habit, Indian traders resort to hundies rather than properly drawn bill of exchange.
6. **Limited instruments:** The supply of short term instruments like commercial bills, treasury bills etc. are very limited and inadequate.
7. **Limited number of participants**: The participants in the Indian money market are limited. Entry in the money market is tightly regulated.
8. **Restricted secondary market:** Secondary market for money market instruments is mainly restricted to rediscounting of commercial bills and treasury bills.
9. **No contact with foreign money markets:** Indian money market has little contract with money markets in other countries.

Objective of Study:

- Evaluation of relation between Financial Liberalization, Financial Development and Economic Growth in our country.
- Emphasizing the significance of Monetary Policy in our country to promote Financial Development and Economic Growth.
- Evaluation of relation between economic growth and financial development along with the evaluation causality between the both in our country.

Significance of the Study

It is necessary in our country to talk about the coordination between Indian financial market and monetary policy as it would be helpful for off-setting macroeconomic instability in our economy. From the time of independence, government studies the aims of monetary policy and then acquires parliamentary endorsement where RBI has freedom about the usage of monetary devices for completing these aims. Therefore, financial market of our country takes high road over monetary policy. There was an IMF survey conducted comprising 88 constitutions of various nations all across through which it was seen that there are securities for central bank in 30 constitutions and thus it is necessary to study the laws of financial market responsibility and independent monetary policy.

Literature Review

1. Fase and Abma (2003) examined the practical relationship between economic growth and development in south east Asia by using the information for 25 years. They also analyze that economic growth depends on financial development and that occasionally runs from economic framework to development . the outcomes recommended that in developing nations a policy of improvement of finance could also improve economic growth.
2. Boyd and Smiths (1996) explained the co-revolution of the original and economical sectors of the economy as it develops. They proclaim that economical innovation is a energetic process that both affects by the real sector. As an economy grows, The mass ratio of debt to equity commonly falls; ye, debt and equity market works as complements despite than substitutes in real growth of the economy. They examine that the growth of the equity markets occur associatively late in the financial growth method because of the frictions in the economical market. As these conditions become less drastic, the economy gets more profit for more successful functioning set of stock markets.
3. La Porta et al., (2004) concentrated on the consequence among legal environment in which the banks and capital markets work and entire growth of economic institution.
4. Shleifer and Vishny (1992) in their article, "Liquidation Values and Debt Capacity: A Market Equilibrium Approach", talked about resource liquidity and ideal influence. They contend that in expenses of budgetary troubles, resource liquidity assumes a significant job as a determinant. Their paper is centered on industry and economy wide determinants of liquidity.
5. Rajan and Zingales (1995) broke down Germany market to clarify connection between capital structure and its segments. Their outcome can be a clarification of the observational discovering which firm size is contrarily identified with influence in Germany. This negative impact is for German capital markets which are less evolved and simply huge firms are exchanged open.

CONCLUSION

Money markets play a key role in banks' liquidity management and the transmission of monetary policy. In normal times, money markets are among the most liquid in the financial sector. By providing the appropriate instruments and partners for liquidity trading, the money market allows the refinancing of short and medium-term positions and facilitates the mitigation of your business' liquidity risk. The banking system and the money market represent the exclusive setting monetary policy operates in. A developed, active and efficient interbank market enhances the efficiency of central bank's monetary policy, transmitting its impulses into the economy best. Thus, the development of the money market smoothes the progress of financial intermediation and boosts lending to economy, hence improving the country's economic and social welfare. Therefore, the development of the money market is in all stakeholders' interests: the banking system elf, the Central Bank and the economy on the whole.

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