

Money and Banking
Prof. Dr. Surajit Sinha
Department of Humanities & Social Sciences
Indian Institute of Technology, Kanpur

Lecture - 14

We are with money market and I was giving you an overview of a financial system which contains money market. And some of the things that are involved technical words like, underwriters brokers dealers various kinds of institutions that are there in India, intermediary, non intermediary, and all that regulatory. Then that business of risk free market as opposed to risky market, share markets, gilt edged market I was talking about those things.

Now, today what I do in that tree that I had the slide there was one item in the middle at the end of the top first row called financial instruments. So, if I have to talk about in details about the money market, I need to talk about the money market instruments and money market is a short term financial market. Money market is never long term, the capital market is medium term and long term money, but market is a short term. So, which way to start, so I want to start with the most popular ones in the money market, there is a lot of discussion and utility of these markets, it is called the call market.

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Let us start talk about the call market. Call market is a very short term market, money market where call money is very short term money, but there are two other kinds of

money which are not very short term. So, call market you have call money this is an instrument through which money changes, and from one person one institution to another institution call money very short term.

The two more moneys are there one is called notice money another called term money, now this call money, notice money, term money their maturity varies like when you have to return the money. Maturity means the money that you have lent will come back to you or who has borrowed it should return it, that is the maturity when it expires the life of the money.

The call money expires is very interesting in 24 hours, so you borrow money for 24 hours and imagine how short term it is. So, call money you borrow for 24 hours, notice money maturity can vary between 2 to 14 days, and term money maturity can vary between 15 and 90 days, which is essentially a fortnight to 3 months. So, they are very short term I told you money market is very short term, they are very short term very why because short term can go up to 1 year it is very less than 1 year, the call money matures in 24 hours which is unbelievable.

Now, let me explain what is this money market, it is very important I tell you, so I took up the market which is very important and also very well known. Banks at the end of the day they are dealing with cash, is coming in cash is going out people are withdrawing, loans are been taken, CRR money is getting ready. At the end of the day particularly at the end of the week banks have to get ready with CRR cash for RBI in India, now I have come down to India now, but that does not mean call money is not there in other countries every country has, but now my focus will be India.

Because, you would be working in India primarily and the jobs that you will have tomorrow, so you should know this and then you can expand your knowledge later. So, now, banks when they sit down and do this accounts they see (()) CRR cash mismatch, miscounting, miscalculation, what to do, then they go to the call market and borrow money. And it can also happen during the week, they are doing a business deposit is come they keep up calculation (()) CRR this much this much excess reserves with us, for them to borrow.

The depositors we can give out loan, some loans where big loans were supposed to be returned the cash was not returned. Again they are short of cash, but they need the cash

for 1 day, 2 day, 2 weeks, 3 weeks, 1 month maximum, where to go. To somebody who has the cash I am coming to that who has the cash it is usually, another bank which has the cash surplus who makes a quick money means income by just lending it to another bank, and banks know each because it is very safe.

It is not an unknown investor walking in to the manager's office saying that, I want open a company and these are my, you know papers, I need a loan. He says my goodness let me do the research work now, where is your company, where you want to form, who are the people, what kind of finances you have from your side, you know enormous amount of questions investigation kind of a thing CBI investigating, and then the money is given to him.

Here banks know each other they are in business every day, they are in the fraternity belong to the same club called commercial banks. They often lend each other and the story in India is call market, the main supplier of money cash, to other banks is, the state bank of India. State bank of India has the maximum surplus cash usually, it is the largest public sector bank, it is the largest commercial bank in India among all banks maximum number of branches, you will see of state bank of India it has the maximum amount of cash surplus cash.

So, call money is very interesting quick money, short notice money you need cash, depositors are withdrawing suppose 2 months. Say the festive season is a classic example, during festive season people go out of the way, to spend either it is (()) or it is the Dussehera time or Holi time whatever in foreign countries it is the Christmas time for instance new year. So, there is a huge drain of cash from the accounts, people who do not have much money would nearly empty their account to buy things alright.

That is when and now you have given out loans, which suppose there are not proper timings or loans are not supposed to be returned. Even that can be the case then you need the cash otherwise the depositors will panic where is my money, I put it in your bank that is another story banks getting into trouble. So, call market is, so sensitive, there is any change in macro economic situation in a country, call market immediately starts giving signal particularly if it has to do the financial market.

The recession set in the western market, in the western countries alright, people panicked withdrew cash Indian stock market started going down alright, they were withdrawing

cash, they invested money say the N R I investments. They came into portfolio investments etcetera, and now they started withdrawing, it withdrawing where people do not hold the cash when they invest, they all go to the bank deposits. So, banks started giving out that money, the call market immediately should I will show you the data how sensitive it is, I will come to the data and you would ask me which you did not.

That this call market which has 3 types of money, the principal one is the call money 24 hour maturity, how is the discount rate or the interest rate determined. The interest rate for instance, the call rate it is called the call rate how is the call rate determined, the call rate is determined by simple supply demand kind of a market mechanism. If the supply of cash is more than the demand, call rate will be down. If the demand suddenly increases more than the supply, what it exists demands are shifting out the call rate would shift start climbing up, as soon as demand falls the call rate starts coming.

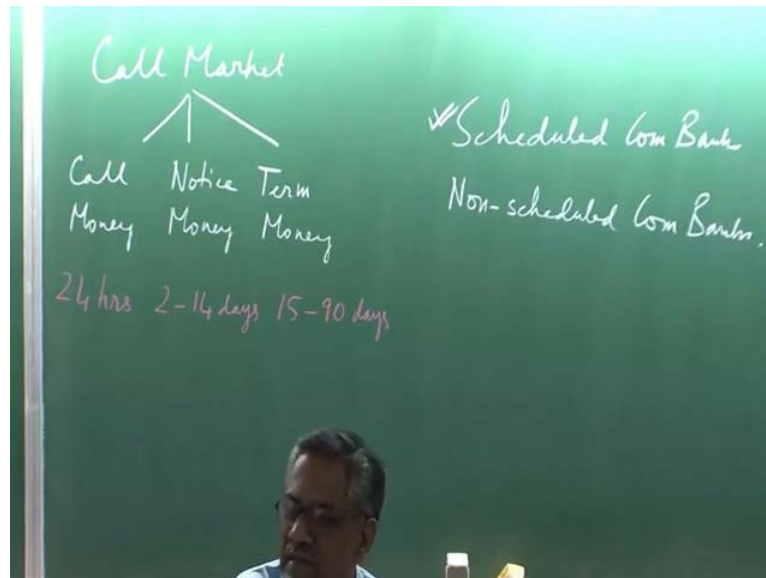
So, call rate hour to hour it fluctuates like the stock market index I tell you, but I do not want to show you that hour to hour data, I will show you a very average data say a monthly average or something or a yearly average based on monthly averages. I will show you data call rate is that sensitive, like you know any very living thing, who can who is something like say the body temperature or the concentration levels of a human being changes. Minute to minute it can change hour to hour it can change, depending upon like, you are walking in to an exam hall, it will change completely.

So, call money is one of the most sensitive most important part of the money market of any country in India, it is true it is the same thing. And the call rate which is the interest rate that the borrower pays the lender is determined by the demand and supply functions, very simple. So, it goes back to the original thing that I said there are the deficit unit is and the surplus units, this transaction essentially is part of the core of the financial systems.

Now, when call money started in India way back in the 60s I think, then if you go back to that data I would not go back you will see that the participants in the call market, either as a borrower which is usually the banks. Non banks could have borrowed also, if they need cash, and the lenders who make money quick income by being a supplier in the call market like, LIC for instance can be participating in the call market it has a huge amount of cash. What I found is if I go back to the old books, I found all kinds of

commercial banks were participants, either foreign or domestic. And here I want to just mention one word which will not make much sense, in India you have two kinds of commercial banks according to the classification given by RBI.

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And you would often come across this term in RBI site, on RBI site on in books, they are called scheduled commercial banks; that means, there are non scheduled commercial banks also. This one you will hear, the other one you would not hear you would not see on RBI site, the non scheduled commercial banks are essentially there is a classification difference, I will talk about that later in topic 5. RBI classifies banks, they are all licensed not that they belong to unorganized sector only that will be non scheduled of course, scheduled banks enjoy certain privileges.

That RBI say RBI can help them RBI asks them to maintain a CRR, and they keep the CRR cash which they used to help them etcetera, etcetera. So, scheduled banks if you become a scheduled bank like all other registered students, but I am saying that some are scheduled registered students, some are non scheduled registered students. If I do that which does not make much sense here, in this context, what it basically means that the non scheduled banks do not have up to the mark performance, and RBI has not given them the status of a scheduled commercial bank.

If you are a scheduled commercial bank, RBI gives you a number of privileges facilities, they provide lending etcetera apart from CRR and other things cash that they use. Now,

initially in the call market all types were operating scheduled as well as non scheduled, and remember one thing I showed the data many years back some years back, one year back. The banks that you see today as state bank of India and united commercial bank and united bank of India and all that, they were mostly private sector banks, with single ownership or private partnerships etcetera.

Now, they were about 20 to 21 banks were nationalized and they became therefore, public sector banks only in 1969 mistress Indira Gandhi did that, now the call market existed before 1969 in India. I do not know exactly when the call market started, but it existed, now those days you had the classification scheduled non scheduled RBI said that, but banks were not nationalized and everybody was participating in it.

Now, after it became nationalized it became clear that the government gave a special status RBI, on behalf of the government to the scheduled banks to come in and the non scheduled banks to go out. Simple reason is you cannot trust the non scheduled banks, if they fail to make the payment when they borrow, RBI cannot intervene it has to be criminal procedure through court which takes number of years to resolve. Court proceedings are horrendous in India, if it begins, now non scheduled and scheduled both types were operating in the call market.

And after the nationalization of banks famous 1969 nationalization, when you had all these bank of Baroda and all that name that you see. They all ownership got transferred from private hand to public hand; that means, government, and they were few private sector banks left, and I do not remember foreign banks when I was growing up. I remember some foreign companies, like American express etcetera had an office in Calcutta I do not remember seeing Deutsche bank and Hong Kong bank and whatever you have.

Now, Citibank, Standard Chartered never seen them in my life, all banks we had in the neighborhood and in the larger neighborhood one is an immediate neighborhood and the larger neighborhood. Wherever, I went were all public sector banks united bank of India, united commercial bank state bank and state bank has subsidiaries also, state bank of Mysore, state bank of Hyderabad, state bank of Bikaner.

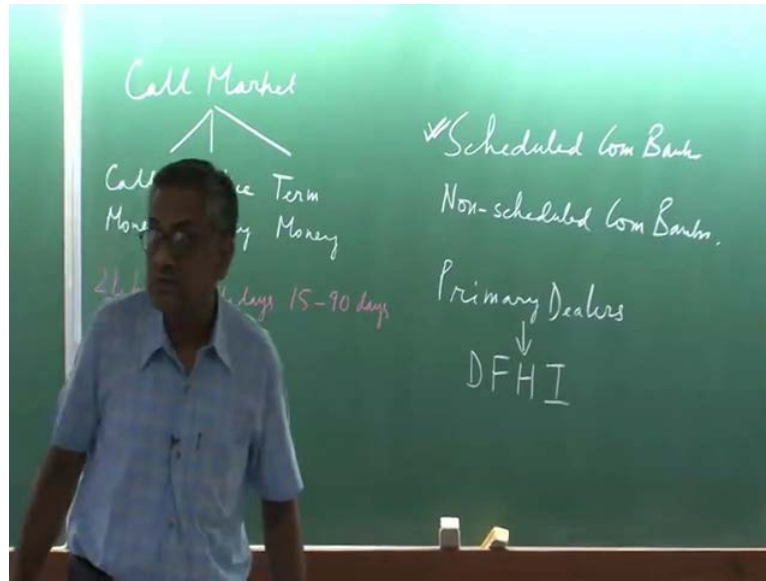
They have they have subsidiaries also, they all got nationalized and initially, state bank used to have another name you know the name anybody knows the name pre

independence name, state bank was not called state bank. It was a name given to it much later, and it became the largest (()) very good imperial bank of India. Those days imperial word was more popular, so imperial bank of India it used to be called, and then call market participants were also cooperative banks.

I will talk of cooperative banks later, they are very unique thing about Indian economy, it does not exist in many other countries cooperative banks. And in fact, cooperative banks cooperative organizations, I have seen started in India the movement you can say opening of cooperative societies and cooperative banks etcetera, as far as as early as 1907. They were first established 1907, beginning of last century then you had the non banks, as I told you LIC etcetera they have surplus cash, so if banks want cash, they are the obvious supplier of cash alright.

And LIC was founded in 1956 or so... So, by the time banks were nationalized, the call market was functioning properly and the banking sector was developing well, early 70's onwards LIC was a big player there and other non banks also. There were other non banks like U T I etcetera, they all had cash and were participating in the call market, then you have these I will talk about I mentioned that yesterday RBI created something agents. RBI's direct agents like brokers, in the share market they mediate between second hand second hand transactions of shares brokers and you had the underwriters, the big guys for the primary shares. Now, RBI created for the government sector bills etcetera, RBI created primary dealers it is just new concept.

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So, primary dealers, I will talk about all these institutions later, but just know the names these are directly under RBI, RBI gave them permissions. Usually, public sector banks are primary dealers some of the public sector banks and some institutions are there. One of the most important institutions or primary dealer in India which was founded in the early 80's is called the Discount and Finance House of India, DFHI.

The Discount and Finance House of India I will talk about that too later, one of the most important primary dealers in India. That was founded in early 80's now these are the institution who were primarily functioning alright. Now, reforms started 91 doctor Manmohan Singh and company, reforms were just not with the real economy, reforms were also there with the financial economy. And by the mid 90's when the first phase of reforms were coming to an end and also the government came to an end, the plan also came to an end, it was the 8th plan.

If you remember 1992 to 1997 alright, before the plan ended the government ended, then there was uncertainty political uncertainties. And so around 1996, 97 something dramatic or reforms started happening, as I told you right from the beginning non banks etcetera were participating, because if you look at the if you look at the banking sector those days, it was not very well developed. This is not lot of cash the economy was very small, now the economy is huge compared to those days.

So, the cash that you transact in the economy is large, so every bank has a larger share of that cash the money supply, now those days when banks were in trouble etcetera, the call market is essential for the survival CRR SLR were all there. So, LIC was asked to participate, but today you do not need the help of LIC any way, we do not need the help of NBFIs and they were primarily lending, they were not withdrawing cash. They were not borrowing in the call market, banks were borrowing question is who is going to lend to them.

Remember, call market is primarily to help out the banks, the question is are there banks to help the banks or you need the non banks also. Those days non banks were important, because LIC was a big institution in India there was no insurance company, so people bought insurance from them. So, they naturally had cash and they were asked to help them out, the call market now what happened in the 1996, 97 etcetera that economic survey I remembered looking up, dramatic changes happened they withdrew the NBFIs..

So, withdrew the NBFIs mutual funds, but they kept primary dealers there, because NBFIs were not under the direct control of RBI, but DFHIs and primary dealers PDs were under the direct control of RBI. So, RBI was basically reorganizing the entire call market structure, NBI mutual fund maybe share market or something alright or give it to other NBFIs invest there. And they left call market primarily under the operating zone of the banks of course, in addition to the banks that primary dealers became very important.

And primary dealers became very important particularly DFHI discount and finance house of India, which was the earliest primary dealer. Now, you have more primary dealers about 13 or, so I have forgotten the number 13 or 15 primary dealers, that used to be the most important primary dealer in the 90's it still is very important. So, it left the market to the banks to operate, and outside organizations other than banks were DFHI and some other primary dealers RBI therefore, RBI has been doing this kind of a thing therefore, can take it is hands off.

Do not have to worry about the call market, because it has given the responsibility to DFHI which is a subsidiary in some sense of RBI, this is exactly what they have done with nabad RBI. Nabad used to be department of RBI, then suppose mechanical

engineering, tomorrow you ask mechanical engineering to become independent. So, the study regarding mechanical engineering IIT Kanpur does not bother any more worry any more it functions autonomously.

So, nabad used to be a department I have forgotten the name of that department, department of agriculture and something, something, something was there which has become nabad. Now, it functions autonomously and it functions so well that it does not take a single pie from RBI to function. So, DFHI has become very independent today and it functions and RBI's headache is over, because how much headache RBI can take RBI has a lot of headaches.

It has the foreign exchange market headache, it has the government deficit budget headache, and entire government bills market headache alright, then it has the monetary policy. So, RBI is a mammoth organization, central bank usually it is true in all other countries, but it has what it has done it has decentralized it is responsibilities. You do this you do that I do not have to worry if you are in trouble need help then come to me, otherwise you function autonomously.

So, the call market is very interesting to do, you have the scheduled banks, I am coming to that and cooperative banks are there, both commercial banks and cooperative banks are there primary dealers which have become very, very important. And I have a date here it is very interesting 1996, 97 it started and then I have a date from economic survey 2005, 06 many years back I have written here, in italics. Effective 6th august 2005, effective sixth august two thousand five the non bank participants except primary dealers would be completely phased out from the call market, economic survey 2005, 06 page 55, completely phased out.

There will not be a single non bank participant, it is entirely the banking sector you manage your funds help each other out, and you will have the primary dealers to help you in case the banking sector does not have sufficient help to give to their fraternity to their fellow banks, completely phased out. Now, I will take your question, you have a question.

Student: (())

They are under yes they are accountable, there is some regulation, but they largely function autonomously just like IIT Kanpur.

Do you see government of India's that ministry MHRD, Ministry of Human Resources and Development, any minister or ministers undersecretary or joint secretary sitting here, and communicating as an office and communicating with the director and the registrar and the deans. It is a government of India organization, but government of India does intervene if required there was some intervention recently about the pay scales first and then the JEE, some interventions you must have read the newspapers. But, that is not a regular affair, regular affair of IIT Kanpur is run by IIT Kanpur, so day to day business of nabard whatever it is they do primarily agricultural sector lending activities. They do that, but that does not mean RBI does not have any say in it alright,

If RBI (()) private organization

If RBI,

Private organization (())

RBI can never be a private organization, Central Bank central can never be a private organization, who said that Federal Reserve Bank in US is registered as a private organization. Federal Reserve Bank, where have you read, Wikipedia is a dangerous place to go to I have never heard.

(()) Sir, because there has been recently a documentary same thing was whatever the government spends on the public is borrowed from the market. So, that is why the public that is why they were saying that federal reserve is not under the government. (()) that is the nature of any central bank for instance it is independent or government any spending that the government is doing it in terms of borrowing from RBI (()). So, it is not in the government control, but it is not a private institution an independent institutions.

I cannot imagine central bank of a country will be a private organization.

Student: Sir it is not a private organization, but it is still it works under (()).

I will check that out myself, the ownership pattern of these organizations the central bank, we usually call the central bank the arm of the government, it is not completely

independent of the government in some countries like US is very independent in countries like India. it is not so much, but that does not mean central central banks are entirely private organizations, because I am not so sure I have to check that out, any other question.

Student: Sir what is the difference being a private organization and government organization?

Private organizations in the sense it depends what kind of private organization, you are talking about you are talking about a public limited, private limited corporate company. Then you have to go to the company board get yourself registered, there are rules are regulations, if you are opening a partnership joint partnership or single ownership company there are registration processes.

If you are a cooperative sector organization, which is not public, you have to get the registration done with the cooperative department of the state government, every state government has a cooperative department in India. Now, if you are talking about a public sector company, it is its formation is very different, usually the entire share the finances are entirely held by the government. The registration is very different, if it is a government company, like air India, Indian airlines then the petroleum companies, there used to be steel companies, fertilizer companies, many, many companies.

Their registration is very different they are not corporate sector companies. They are publicly owned companies means government owned companies, and central bank I always thought is an organization which is part of the government in some sense. Though, it functions autonomously, this is what I always thought (()), now I will check out the registration details of these banks, central banks what they are saying. Commercial banks can be private and in India it can also be public because government has nationalized them, we have something called nationalization.

Industries can be nationalized, companies can be nationalized, banks can be nationalized, LIC was formed through nationalization, there were small, small life insurance companies at the time of independence. After independence government of India brought all of them together and formed a joint company called LIC, since then it is called LIC life insurance corporation of India. They were all pre independence they were all small, small life insurance companies privately owned, they were not doing well some of them

were doing well, then what happened after independence was government put them all together and formed LIC.

Similarly, our commercial banks originally were all private owned firms companies were there, then there were nationalized because they were not doing well, but dealing with public money people's money. So, government feared that they may default on that they were defaulting, so government nationalized, once you nationalize it becomes headache of the government. Even if they are not running at a profit government will always bail them out, they were nationalized 1969 it was done GIC companies, were all private companies.

They were all put together called GIC, General Insurance Corporation, now so you have seen the call market. Now, where are the call markets main markets operating in India. The main call markets that are operating in India are according to my notes Mumbai of course, Kolkata, Chennai, Delhi and Ahmadabad, main call centers call market centers not call center call center is a different word, today main call market centers are Mumbai, Kolkata, Chennai, Delhi and Ahmadabad and this the call market I let me give you a number which is a very old number, but still I give you a number.

Say before during 91, 97 the first phase of the reforms, 91 to 97 the average daily turnover in a call market the amount of money borrowed etcetera. And lent average daily daily remember average daily during 91 to 97 was roughly about 6000 crores of money borrowed etcetera, 91 to 97. Now, ten years later around 2007, 08 this average daily turnover you would understand, how the Indian economy has grown average daily turnover in the call market has become 21,393 crores. So, from 6000 to 21000 more than 300 percent increase.

Student: (())

Value of money has also fallen sure due to inflation, but the total turnover in the call market has increased, now if you look at the average daily turnover I can get the data from RBI site. I do not have it in say 2010 11, so it will be enormous, but let me give you a little bit of history about call market, how badly it was functioning around December 1973, banks were nationalized in 1969 and December 1973 when the oil price shock came.

In Indian economics you learn that oil price shock came, the call market the call rate in the call market reached the maximum ever in Indian history, call market history the interest rate was 30 percent. That means, there was, so much of shortage of funds, and RBI was not helping the call market properly so that is why it happened. Since then till roughly about Rajiv Gandhi's days of 1988, 89, 90 Rajiv Gandhi's 7th plan, since then Indian bank association got, so furious that RBI was not helping them much.

And there were not sufficient supply of funds in the call market and the rate can go to 30 percent, huge amount of 30 percent on 1000 crores I brought, imagine if I borrowed how much interest you are paying, so they got furious. So, Indian bank association, is the bank association, Indian bank association, they got together and put a ceiling on the call rate it was initially 15 percent and then reduced to 10 percent it can never go up above 10 percent.

So, what it did the ceiling you know in the market supply and demand analysis, if you put a ceiling it cannot go up there would always be excess demand for call money, because the ceiling is usually below the equilibrium crisis. So, the demand is more than supply alright, normal case if there is no ceiling it will climb up to 30 percent, but if you put a ceiling way down to 10 percent 15 percent. That means, there would there would be huge imbalance, in the market in terms of supply of call money and demand for call money and the demand for call money would be large very large clear.

Now, but then after 1988 before the reforms started market started deter; that means, the call money eased, there are lot more players in the market those days NBFIs etcetera became larger they were intervening, they were participating. They said now we can transfer to the free market call market again, but then the market rates have gone up a lot at times. So, I will show you the call rates, in India remember just one thing, in the current period I do not have all the data, one is the bank interbank call rate, that is banks borrowing from banks.

But, RBI has also created the primary dealers and particularly DFHI is operating in the call market, and DFHI is like the letter of the last resort or something like if you do not have money from one of the banks you go to DFHI. So, what we effectively find today in the call market in India, there are at least two rates the interbank call rate and the DFHI rate. I hunted and searched and searched RBI's site I have not got any DFHI call rate

data as of yet, last 5, 6 years I am looking for it I interestingly enough RBI although primary dealers are RBI organizations, created by RBI there is no DFHI call rate that I found.

So, the only call rate data that RBI publishes is the market call rate which is between the banks, lending and borrowing, which is called interbank call rate is very funny. I have to write to RBI some day and say why do not you publish the DFHI call rate also the data they do not show it DFHI data, but I have been told I have heard that there are at least two call rates operating at any time. The DFHI rate call rate and the interbank call rate now I am going to tell you something one last point before you go away, and tomorrow we do not have a class also.

We will meet day after tomorrow do not think that the call market is the right or the privy of the organized money market like the banks etcetera what we call. There is very active call market in some parts of India which belong to the unorganized sector, can you believe that. There are unorganized money markets which have not been nationalized or they have not willingly come and become part of the organized money market. In places, like Gujarat like Saurashtra, for instance this is a fascinating area, where you will find century old banks which are in the unorganized sector.

There is no CRR, no SLR, no RBI, no registration as such. But, they are operating as a practice as a habit and the RBI has not stopped them completely, put them in jail has not done that. That unorganized sector banking sector is there, in some places some pockets of India like saurashtra in Gujarat. Where it is just like organized sector banks if those banks need funds they are short of funds, they borrow from each other and there is a call rate also.

So, we have call market in India god knows for how many years, the call market that we usually talk about is the organized sector call market, which where we will give you interbank call rate etcetera the DFHI also has a rate. But, actually there is a call market operating in India for centuries probably, where these various parsi people and all those money oriented people who migrated centuries back from middle east and are in business. They have opened banking systems and running banking systems which were never part of the organized sector banking system.

Banks which we do not know even, and there are also those banks also have those pockets of India have also a call rate, but I do not have any data, RBI does not supply any data. What kind of call rate that exists, they have a call money there money is borrowed there, at short notice or for shorter duration. So, therefore, you have three call rates at least in India unorganized sector general call rate, but it will vary I think from part of country to another.

If you go to Tamil Nadu where also you have these unorganized sector banks called Shettias age old Shettias which never became part of the organized sector banking system Tamil Nadu banking system unbelievable. There can be a call rate in Saurashtra Gujarat you have called so these are general unorganized sector call rate, then you have the famous call rate which we have in all countries the interbank call rate. We also have in India I will supply data on that variable and of course, you have what I have been finding out gradually, is that there is a DFHI call rate also which is slightly different from the interbank call rate, DFHI operates in the organized sector of course.