Money Markets

The money market is a market for overnight to short-term funds, and for short-term money and financial assets that are close substitutes for money "short-term", in Indian context, generally means a period upto one year; "close substitute for money" denotes any financial assets that can be quickly converted into money with minimum transaction cost and without loss in value.

The major participants in the market are the commercial banks, the other financial intermediaries, large corporates and the Reserve Bank of India(RBI). Being the residual residual resources of funds, RBI plays a pivotal role and occupies a strategic position in the Indian money market. By varying liquidity in the market through various instruments, it influences the availability and cost of credit. In fact, a developed money market contributes to an effective monetary policy.

The broad objectives/functions of the money market are to provide:

(i)An equilibrating mechanism fo evening out short-term surpluses and deficiencies.

(ii)A focal point of central bank (RBI) intervention for influencing liquidity in the economy and

(iii)A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost.

Features

The money market has certain distinct operational features as compared to the capital market. First, while in the money market the operations are for a short duration in the capital market they are for longer durations/periods, although at times the distinction/demarcation between the two segments of the market is not clearly market out. The volume of funds/financial asserts representing the money traded in the market is very large.

Finally, the money market consists of a number of interrelated submarkets such as the call market, the commercial bill market, the treasury bill market, the commercial paper market, the certificates of deposit market an so on. The main objective of this Chapter is to present a summarised view of the money market in India.

The focus is on its organisation/structure and not on quantitative growth. The focus is also on describing the current scenario in contrast to th historical evolution/past history. The RBI is the most important constituent of the money market organisation.

The aims of its money market operations are three-fold:

(i) To ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability;

(ii) To ensure an adequate flow of credit to the productive sectors of the economy; and

(iii) To bring about order in the forex market.

Monetary Policy

According to Reserve Bank of India, Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

Moreover, monetary policy refers to the policy of the central bank with regard to the use of monetary instruments under its control to achieve the goals specified in the Act. The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

The goal(s) of monetary Policy-

- The primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition to sustainable growth.

• In May 2016, the Reserve Bank of India (RBI) Act, 1934 was amended to provide a statutory basis for the implementation of the flexible inflation targeting framework

. • The amended RBI Act also provides for the inflation target to be set by the Government of India, in consultation with the Reserve Bank, once in every five years. Accordingly, the Central Government has notified in the Official Gazette 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

• The Central Government notified the following as factors that constitute failure to achieve the inflation target:(a) the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or (b) the average inflation is less than the lower tolerance level for any three consecutive quarters.

• Prior to the amendment in the RBI Act in May 2016, the flexible inflation targeting framework was governed by an Agreement on Monetary Policy Framework between the Government and the Reserve Bank of India of February 20, 2015.

The Monetary Policy Framework

- The amended RBI Act explicitly provides the legislative mandate to the Reserve Bank to operate the monetary policy framework of the country.

• The framework aims at setting the policy (repo) rate based on an assessment of the current and evolving macroeconomic situation; and modulation of liquidity conditions to anchor money market rates at or around the repo rate. Repo rate changes transmit through the money market to the entire the financial system, which, in turn, influences aggregate demand – a key determinant of inflation and growth.

• Once the repo rate is announced, the operating framework designed by the Reserve Bank envisages liquidity management on a day-to-day basis through appropriate actions, which aim at anchoring the operating target – the weighted average call rate (WACR) – around the repo rate

. • The operating framework is fine-tuned and depending on the evolving financial market and monetary conditions, while ensuring consistency with the monetary policy stance. The liquidity management framework was last revised significantly in April 2016

Instruments of Monetary Policy

There are several direct and indirect instruments that are used for implementing monetary policy.

1. Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

2. Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

3. Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

4. Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

5. Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

6. Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

7. Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.

8. Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

9. Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

10.Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of shortdated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

SOURCE-

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