The Indian Money Market

In India, all the larger commercial banks have been nationalised. Of the 273 scheduled commercial banks[1] at end-1986, 28 were public sector commercial banks,[2] 194 regional rural banks[3] (which are also regarded as being in the public sector), 30 were private sector banks, and 21 were private sector foreign banks. There were 3 non-scheduled banks. The 28 public sector commercial banks included the 14 large commercial banks nationalised in 1969, the State Bank of India (SBI) and its 7 subsidiaries, and the 6 additional banks nationalised on 15 April 1980. These accounted for over 90 per cent of aggregate deposits of all commercial banks in India. Hence, the remaining banks must bave been very small.

In addition, the community was served by a network of cooperative banks — at end-1985, 28 State cooperative banks (of which 14 were scheduled banks), 350 central cooperative banks, 1,259 primary cooperative banks (urban cooperative banks), 8 industrial cooperative banks, 91,749 primary agricultural credit societies, and 25,203 primary non-agricultural credit societies. These institutions mainly provide short-term credit. The medium- and long-term credit institutions in the cooperative sector comprise central land development banks and 896 primary land development banks. The membership of the cooperative movement exceeded 106.9 million. These banks are supplemented — particularly in South India — (a) by chit funds, which accept and pay interest on monthly deposits against which it is only possible to draw by way of loan; money can also be borrowed against fixed assets; and (b) by nidhis, which

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[1] Banks included in the second schedule of the Reserve Bank of India Act and having paid-up capital and reserves of not less than Rs. 5 lakhs or Rs. 500,000.

[2] Strictly speaking the State Bank of India is not a wholly nationalised bank; as much as 7 per cent of its shares are held by private individuals. In the case of the 7 subsidiaries of the SBI, three of them are fully owned by the SBI, while the remaining four also have individual shareholders.

[3] Set up under the Regional Rural Bank Ordinance 1975 to provide institutional credit to rural people; they are mostly sponsored by one or other of the nationalised commercial banks and have increased rapidly in number over recent years. In particular, they have served to increase the flow of credit to small borrowers in rural areas. They have a specified area of operations.

are mutual loan societies which have developed into semi-banking institutions, but which deal only with their member shareholders.

In India, there is still a large but unknown number of indigenous bankers and moneylenders, who, particularly in the rural parts of India, continue to provide part of the available banking and quasi-banking services. However, under new arrangements, first in the form of the social control of banking and then with the nationalisation of the largest Indian commercial banks, the commercial banks accelerated the opening of more branches in rural and semi-urban areas in order to complement the facilities already offered by the SBI (and its subsidiaries) and by the cooperatives.

The core of the Indian money market is the inter-bank market, which is centralised primarily in Bombay, but with sub-markets in Delhi, Madras and Calcutta.[4] All the major banks have large networks of branches. Information about the cash/deposit position is fed into regional and zonal offices and, through them, into Bombay; there is also a certain amount of forecasting over the cash reserve period calculated on an averaged basis on alternating Fridays. The statutory liquidity ratio is based on the position a fortnight earlier. On the whole, both the big banks and the smaller ones know their money position for the day either the night before or early next morning (say, by 10.00 a.m.), though some banks may not know final figures until perhaps 11.30 a.m. (even 1.30 p.m. some days); and, because movements of funds can be quite large during the course of a day, adjustments have to be effected virtually up to the time the market closes.

If banks wish to borrow at the Reserve Bank of India (RBI), they would normally do this by 2.45 p.m. — they have a limit up to which they can borrow at any time. This would be at Bank rate (10 per cent).

[4] The Bombay inter-bank market opens about 10.45 a.m. for 11.00 a.m. operations (10.00 a.m. on Saturdays). Banks are open to the public, it should be noted, from 11.00 a.m. to 3.00 p.m., Saturday 11.00 a.m. to 1.00 p.m. The market is very active between 12 noon and 2.00 p.m. The busiest period of the day seems to vary somewhat between the big banks, but the majority of the larger banks seemed to think the market was busiest from 1.00 to 2.00 p.m. The timing of the busy period seemed to vary by size of bank — usually the big ones operated more quickly — and on whether money was easy or short (when money is short the adjustments tend to be longer drawn out). Delhi opens at the same time as Bombay, but closes at 2.00 p.m. After 1.00 p.m., lending banks would put money out in Bombay. Madras and Calcutta open at 10.00 a.m., some at 9.30 or 9.45 a.m. in Madras. Both in Madras and Calcutta, the market closes at 2.00 p.m. Again, the busiest time varies — for a large bank in Madras 10.30 to 11.50 a.m., for a small bank 9.45 to 10.15 a.m. In Calcutta, the busiest time seems to be 12 noon to 1.00 p.m. On Saturdays, both Madras and Calcutta are open from 9.30 a.m. to 12 noon. Late in the day, Calcutta like Delhi would put its money out in Bombay. There the market virtually closes down by 2.45 p.m. (all cheques have to be cleared with the Reserve Bank of India — RBI — by 3.00 p.m.).

They can also borrow to refinance advances to the Food Corporation (at a rate of 11.5 per cent) and on the basis of export bills (9 per cent). Finally, the RBI may make money available to the banks on a discretionary basis and at a penal rate — Bank rate +4 per cent (*i.e.* at 14 per cent during that latter part of 1986). These moneys must be borrowed by 3.00 p.m. and may be for a fixed number of days (up to 14), but thereafter with gaps of 14 days. In the event of any mopping up being required, the RBI could increase the minimum reserve cash requirement (if semi-permanent action needed to be taken), or banks can themselves "mop up" by putting money into Treasury bills.

The major lender is the State Bank of India (SBI) — upwards of 50 per cent of the market — which always lends at the ceiling rate of 10 per cent, as do many of the other large lenders. SBI carries a large number of public sector accounts; it also has a low loan/deposit ratio — that is why it has so much money to lend and why it practically never borrows (it last borrowed in January to March 1982). The North Indian banks based on Delhi — even the small ones — are lenders (this is a surplus area) and, although the South of India is a deficit area, two of the big banks with head offices in Madras are for the most part also lenders. The banks with head offices in Calcutta sometimes are lenders. Very often, banks with head offices other than in Bombay will do the bulk of their lending in Bombay and banks with head offices elsewhere will ususally do their borrowing in Bombay through the main branch there. The Life Insurance Corporation (LIC) lends in the inter-bank market, as does to some extent the Unit Trust of India (UTI). On the whole, the larger banks — especially those with head offices in Western India — may be either way; the foreign banks (which lack a developed deposit base because of the restrictions on the number of their branches and/or their high loan/deposit ratios), the banks in South India (also with high loan/deposit ratios), and the private banks are regular borrowers, but may lend from time to time depending on their circumstances. One or two of the Indian banks may lend on money borrowed from other banks and operate fairly regularly on both sides, thereby assisting other banks to make a marginal adjustment. In effect, they are acting as a kind of broker. In order to pay their way, the money on-lent may be put out at a higher rate as an inter-bank deposit, at a ceiling rate of 10.5 per cent to 11.5 per cent, depending on the maturity of the deposit, not as a loan to which the ceiling of 10 per cent applies. These inter-bank deposits could be for 15-30 days, 31-60 days and over 60 days. Excluding SBI, big banks like Bank of India, Punjab National Bank, Canara Bank, Bank of

Baroda, and Central Bank of India, which may also be lenders over part of the year, would tend to become borrowers during the busy season.

Although by no means as pronounced as it was, there is still a busy season in India. Formerly, there was a very marked seasonal movement, to offset which a Bill Market Scheme was introduced, initially in January 1952[5] and subsequently revised in various ways,[6] being phased out and replaced in November 1970 by the Bills Rediscounting Scheme under which scheduled banks could offer bills of exchange to the RBI for rediscount. Latterly, in line with a restrictive monetary policy, the availability of funds under the Bills Rediscounting Scheme was gradually reduced and the facility came to be operated by the RBI on a discretionary basis, subject to the terms and conditions stipulated by it. During the year 1981/82 (July to June) no fresh bill rediscounting limits were sanctioned to the banks and after October 23, 1981 there were no remaining outstandings under the Scheme.[7] Nowadays, the banks rediscount their bills with institutions like LIC, GIC (General Insurance Corporation), and UTI (see below).

As already mentioned, there is still a busy season and a slack season in India (*e.g.* in tea, jute, and sugar), but the economy is becoming more diversified (with the increased importance of industries like engineering and pharmaceuticals) and the effects increasingly diffused. The busy season lasts from November to April, when there is a return flow of government funds (*e.g.* in the form of government grants). There is still financial stringency (*e.g.* in March), which is probably felt more in Calcutta — "the tendency is still there" — but it is no longer an acute situation. Also, because of faster communications, money flows readily from one sector to another (even if rates in Bombay still tend on average to be lower than in Calcutta). In any event, deposit growth tends to show a steady upward trend of about 16 to 18 per cent a year. With an inflation rate of the order of 6 to 7 per cent, there has also been a net real increase in deposits.[8]

If now we look in more detail at the inter-bank money market, one finds that — although it varies from time to time and from bank to bank — more than half the money is lent overnight and the remainder at call

[5] See J.S.G. WILSON, "The Indian Money Market" in *Monetary Policy and the Development of Money Markets*, 1966, pp. 260-1; see also pp. 326-7.

[6] In the first instance, the Scheme related only to internal bills, but in 1963 it was extended to include export usance bills. See B.K. MADAN on "India" in W.F. Crick (ed.), *Commonwealth Banking Systems*, 1965, p. 232.

[7] See RESERVE BANK OF INDIA, *Functions and Working*, Fourth Edition, 1983, pp. 63-5.

[8] See RBI Bulletins.

(for up to 14 days), though in the latter case, too, the money may be lent virtually overnight since the rate will be reconsidered each day and the loan runs on until it is called. If moneys continue to be lent at the ceiling of 10 per cent, it makes no difference. At the end of 14 days, moneys must be repaid before being reborrowed. Usually such moneys run on 2 or 3 days with a maximum of a week. Beyond the 14 days call period, money is classified as an inter-bank deposit at rates agreed by the Indian Banks' Association (for periods of 15-30 days, 31-60 days and over 60 days). However, inter-bank deposits (which are favoured by the urban cooperative banks and the State Cooperative Banks) are said to amount to no more than 1 to 1½ per cent of total liabilities, largely because it is relatively expensive money (10½ to 11½ per cent) and is borrowed for the full period.

All inter-bank money loans are unsecured, but they are subject to internal limits, *i.e.* they are not communicated to the borrowing banks. None the less, borrowing banks would soon discover what their approximate limits were. As a rough guide, limits usually amount to 1 per cent of a bank's deposits (*e.g.* for the foreign banks), but when lending to a nationalised bank a major lender may well go beyond that. It should be noted that LIC has no limits for the nationalised banks, but they do apply limits to the foreign banks and to other non-nationalised banks. But resort to limits is not just a matter of spreading the risk. The main lenders also have to supply funds to so many banks and resort to limits is one way of spreading the money around. Unsatisfied customers can then try somebody else.

Deals in the inter-bank money market can vary to a considerable extent, most obviously by size of bank. They may be as small as Rs. 25 to 50 lakhs, though Rs. 1 to 5 crores[9] is probably the effective minimum, except for quite a small bank. It is difficult to establish the size of the median transaction — Rs. 5 to 10 crores seemed to be quite usual, and Rs. 25 to 30 crores not uncommon. For the bigger banks, Rs. 50 to 100 crores would be quite frequent, but at the upper limit of the market. One large bank stated that — if it needed that amount of money — it would borrow Rs. 250 crores in one deal from the SBI.

Even more difficult is an estimate of the size of the inter-bank money market. It is agreed that the main market is in Bombay and quite frequently outside money is fed into Bombay from centres like Delhi,

[9] Note: 1 lakh=100,000; 1 crore=100 lakhs=10 million. At a rate of exchange of approximately Rs. 20=£1 stg., Rs. 1 crore=£500,000.

Madras, and Calcutta, and not just late in the day. Bombay is said to have a daily turnover of Rs. 500 crores to Rs. 2,000 crores, even sometimes up to Rs. 2,500 crores or Rs. 2,700 crores. Of this, SBI might be responsible for Rs. 1,800 to Rs. 2,200 crores. The turnover is particularly high in March, which is the peak of the busy season, due to withdrawal of deposits to meet year-end tax payments and withdrawal of funds by financial institutions to meet their statutory obligations. Delhi would appear to be the next largest market — say, Rs. 200 to Rs. 300 crores a day; Madras is probably some Rs. 50 to Rs. 100 crores per day; and Calcutta was of the order of Rs. 50 crores, which is a far cry from the days when it used to vie with Bombay in order of importance. Of these amounts, the bulk of the deals would be between the 28 public sector banks; only 20 per cent of the business would be done with the private banks (including the foreign banks, though the latter are proportionately significant borrowers).

In earlier days (*e.g.* the 1950s and 1960s), India had a highly developed inter-bank market with a great deal of activity both in Bombay and Calcutta, with subsidiary activity in Madras. Rates were volatile in both the main centres, though inclined to be more volatile in Calcutta, where long rates were high, but short rates sometimes lower than in Bombay.[10] Madras tended to follow the lead of Calcutta, though it also had connections with Bombay. Up to December 1973 there was no ceiling on rates in the inter-bank market; banks with surplus funds would themselves decide on the rate at which they were prepared to lend; depending on the demand, they could sometimes dictate the rate to the borrowers. Although volatility of rates is normal in most money markets, the authorities became concerned when rates moved up to 25-30 per cent and tended to remain at that level. It was considered necessary for the IBA to intervene and bring some order into the market. It was felt that "high interest rates over long periods would distort the entire banking system's operations and would militate against the basic objectives of planned credit allocation under an administered structure of lending rates". A ceiling of 15 per cent on call money was fixed in December 1973 and in various phases this ceiling was reduced to 8.5 per cent by March 1978. With a resurgence of inflation and the sharp upward movement of the administered interest

[10] See J.S.G. Wilson, "The Business of Banking in India" in R.S. Sayers (ed.) *Banking in the British Commonwealth*, 1952, pp. 209-15.

rates in 1979-80, it was felt necessary to raise the ceiling on the call money rate to 10 per cent in April 1980.[11] There it was to remain. On the whole, it has been respected by all the banks.

But it is an imperfect market with few lenders or sellers of funds and elements of monopoly (*e.g.* as well as SBI, the LIC may have a big pool of money and they only lend at the ceiling of 10 per cent). The majority of the banks are borrowers. Sometimes, the rate comes down below 10 per cent, but only occasionally and really only for marginal amounts (*e.g.* moneys which a bank has attempted to place late in the day, when there was already plenty of money available). Rates in Bombay tend to be lower than in Calcutta. But it tends to be for small amounts or on a Friday when a bank's reserve position may have been misjudged. The "floor" to the rate has been about 4.39 per cent, which was slightly lower than the 3-months Treasury bill rate. But if money is relatively tight, the rate may open at 10 per cent and stay at 10 per cent over the whole of the reserve fortnight.

On the whole, banks do not wish to see the ceiling disappear. One bank active in the inter-bank market feared that the foreign banks (which are regular borrowers) might be prepared to pay more than the ceiling and would tend to force up rates. Another lending bank preferred to retain the ceiling, because otherwise "rates would move around"; one felt that so many banks had become used to it that they were loath to abandon more or less certain market arrangements and had no desire to return to free market criteria. SBI — as the major lender which only lends at 10 per cent — would probably wish to see the ceiling disappear, but recognises that rates could move down as well as up. And a number of other banks, some of which think that 10 per cent is "a silly rate", would also like to see the ceiling go.

In any event, there have already been attempted — and actual — evasions of the ceiling. The most obvious in the T/T discount. For example, one might borrow in Madras today for repayment in Bombay or Bangalore tomorrow (the transaction being effected by telegraphic transfer); for this "service" (which in some circumstances may be a genuine service) a fee or commission would be charged and this would bring total charges up to at least 11½ per cent (10 per cent + 1½ per cent), but more probably to 14 per cent. At such a rate, transactions of this kind would seem to amount to an evasion of the 10 per cent ceiling. Interestingly enough, this technique which is employed in Madras and Calcutta is not prevalent in Delhi. Another technique that may be

[11] See Reserve Bank of India, *Report of the Working Group on the Money Market*, Bombay 1987, p. 5.

employed (though it is frowned on by the authorities) is for a bank to lend Rs. x crores and for a proportion of the loan to be lodged with the lending bank as a deposit, although the rate would apply to the whole loan. This is similar to the "compensating balances" formerly very commonly required of their customers by American banks. Resort to it did not seem to be general. Some of the smaller banks may raise money at more than 10 per cent by arranging a repurchase agreement (RP) — for a week or 10 or 15 days, often 1 month — against government securities; on the whole, however, and especially for the larger banks, RPs are done at less than 10 per cent (say 8½ to 9½ per cent), since such accommodation is regarded as secured. Again, although it is not an evasion of the ceiling, it may be noted that large cooperative banks usually put their moneys out for more than 15 days by way of inter-bank deposits in order to attract a higher rate. Also, all banks seek accommodation by rediscounting commercial bills, particularly with the LIC, GIC, and UTI (see below).

The RBI has banned the payment of brokerage and thereby the activities of money brokers in the inter-bank money market. Hence, all such deals are done direct, though to a minor extent it is reported that the brokers, who also operate in foreign exchange brokerage and may be used likewise in the inter-bank securities market (for both of which commission is paid), do on occasion supply "information" (*e.g.* to foreign banks, which are more used to using brokers); this is done as part of the broker's 'service', which is the leading element in competition. Some of the small banks also find the absence of money brokers inconvenient and the making of deals direct time-consuming. The position has now stabilised and, on the whole, banks are happy to deal direct; they now feel no need for brokers — the banks have got used to it and no commission needs to be paid. This ban was first imposed in February 1978. The reasons for the ban appear to be various — a belief that the brokers "jacked up" the rates, also that there may have been breaches of confidentiality. More generally, the brokers were said to lack professional standards. Whatever the reasons, there is currently very little need for them, since the bulk of the inter-bank transactions is done at the ceiling of 10 per cent. Also, 90 per cent of banking business is in the hands of the public sector banks and they all know each other. In special cases, where banks borrow in the inter-bank market to on-lend to other banks, this kind of business would tend to evaporate if there were a return of money brokers to the inter-bank market. But the argument is not all one way. Even a big bank would agree that if the

inter-bank market were to increase considerably in size and if activity in centres outside Bombay were to grow, brokers might well be needed to assist in handling the deals more efficiently. There would be an even stronger case with flexible rates, where the brokers have a role to play in helping to find the level to which rates will move. Small banks often find that life would be easier if they could operate through money brokers and all banks would find them useful in obtaining money in the busy season, when money is difficult to find whether or not there is a pricing mechanism.

One would have thought there is a case for reconsidering the ban on brokers. Brokers are still active in FOREX, in the trading of government securities, and in the inter-company market, and in raising time deposits for corporations. There is ample experience available; moreover, reputable broking firms would be prepared to come back into money broking. My own view — as I have said before — is that the money brokers provide a useful service and, whatever the malpractices of the past, I would favour a resumption of money broking with the Reserve Bank of India "approving" or "recognising" brokers of repute and I would not worry over much about any accusations of discrimination. In other contexts, in developing money markets, central banks elsewhere have approved of dealers who expected to abide by certain norms. Why not brokers as well?[12]

In highly developed money markets, there is a great dependence on good and rapid communications. It is something we take for granted. Communications are not always as efficient in some of the less developed parts of the world. India is no exception. Of the banks interviewed, which used both telephone and telex, more found communications satisfactory or adequate than those that found them unsatisfactory, though it must be accepted that Indians have no doubt learnt to live with their communications. It was generally agreed that in Bombay there was really no problem, though one sophisticated bank still resorted to a "runner" occasionally to overcome telephone, telex, and/or transport difficulties in Bombay. There was general agreement, too (*e.g.* in Madras and Delhi), that contacts with Bombay were better than with Calcutta, which one bank described as "difficult" and another as "hopeless"; even dedicated or "hot" lines did not always work. Banks with a very active interest in seeking out money (*e.g.* for

[12] J.S.G. WILSON, "Changing Emphases in Indian banking — II The Business of Banking" in *The Banker*, London, November 1981.

on-lending) felt, the lack of really good communications, especially where money had to be sought out across the country. None the less, one sophisticated bank reported that they did not feel poor communications were inhibiting the market. At the same time, better communications could greatly improve its efficiency and will be a *sine qua non* if and when flexible rates return. International communications were reported to be excellent.

A leading alternative to the inter-bank money market is the bill discount market, where bills may be rediscounted up to lines granted to individual banks usually by the specialised institutions. This is more expensive than inter-bank money. Rates on bills are 14 to 15½ per cent to customers, but may be rediscounted at 12½ per cent (which is the maximum but also the actual rate).[13] This compares with the inter-bank ceiling of 10 per cent. It is a market that is regularly in use. With the exception of SBI, which has no need of money, but which does not buy bills either, most banks — large and small — are participants in this market. The relevant paper derives from Triple-A corporations; it is 90-day, two-signature paper (of which one must be a bank signature) — co-accepted bills[14] are not dealt in in this market — and banks regularly in need of funds (including the foreign banks) rediscount usually for 30 days, sometimes for 45 or 60 days, mainly with LIC, GIC and UTI,[15] specialised institutions that often have large pools of money available that they wish to invest short-term. Sometimes a "parcel" of bills will be rediscounted, the minimum amount being Rs. 1 crore. The documents do not change hands and are held by the borrowing bank to the order of the lending institution, which is given a declaration or certificate that the relevant bills are held to its order by the rediscounting bank.

So far Treasury bills have not played a significant role in Indian money market arrangements. Three month Treasury bills are not issued by auction or tender, but at administered rates of the order of 4.6 per cent. These were rediscountable without limit at the RBI. Practice tended to be for banks to place in Treasury bills any large amounts of unexpectedly temporarily available funds for which no obvious alterna-

[13] It is understood that money-rich non-bank houses are prepared to rediscount through brokers at 13½ per cent.

[14] The bill would be co-accepted by the drawee's bank, which may be different from the re-discounting bank; on other occasions, the drawee's bank and the re-discounting bank are the same.

[15] Also with the Industrial Development Bank of India, The Industrial Credit & Investment Corporation of India (ICICI) and to a small extent the Export Credit Guarantee Corporation of India.

tive existed (*e.g.* an excess of reserve balances at the end of the reserve period). Hence, such investments in Treasury bills were not infrequently only for the final day of a reserve period, after which they could be rediscounted at the RBI and the funds returned to the reserve requirement item in the balance sheet. The Governor of the Reserve Bank had already urged banks — in October 1985 and again in April 1986 — "to avoid destabilising the monetary aggregates by volatile movements in their treasury bills portfolio. Despite repeated advice, such volatile movements... continued". The RBI was concerned to reduce the "noise" in the monetary aggregates. One way of resolving the problem (pointed out by the Chakravarty Committee)[16] was to vary the rate of rediscount of Treasury bills. Accordingly, it was decided "to introduce an additional fee on early rediscounting of 91 days treasury bills within 14 days of purchase from the Reserve Bank (the period of 14 days would relate to both fresh bills and recycled bills). The early rediscounting fee would be a little over Rs. 8 per Rs. one lakh face value of bills for rediscounting on the first day and this fee would rise gradually up to Rs. 50 per Rs. one lakh face value of bills on the 7th day; the fee would not rise between the 7th day and the 14th day. Thus the effective yield would be zero on the first day and then rise gradually up to the 14th day. Beyond the 14th day there would not be any additional early rediscounting fee and as such the rate of return would remain unchanged...". This was likely to deter the practice of merely holding Treasury bills for one day.

At the same time — October 28, 1986 — again on the basis of a suggestion by the Chakravarty Committee, it was decided to introduce, initially on a monthly auction basis, a 182-day Treasury bill, but without any rediscounting facilities at the RBI. State Governments and Provident Funds would not participate in these auctions. The discount rate would not be fixed but vary in accordance with the outcome of the auctions. The amounts for each auction would not be fixed in advance. The new instrument would provide an alternative avenue for short-term investments and it was hoped that an active secondary market would develop in the course of time. Major participants in the auction would be the banks and public sector institutions like LIC, GIC and UTI, but corporations and individuals might also apply. The first auction was held on November 27, 1986. Further auctions were held at monthly

[16] *Report of the Committee to Review the Working of the Monetary System*, which was transmitted on April 10, 1985.

intervals. A pre-determined amount was not announced, but — after the bids had been received — a cut-off price was determined below which the bids were rejected. So far the maximum interest rate in the various auctions has ranged between 8.5 and about 9.00 per cent. The growth of the market was expected to be gradual and, by August 1987, outstanding bills under the scheme amounted to only about Rs. 151 crores. From April 1987, a re-finance facility was introduced by the RBI for 182-day Treasury bills. Initially, the refinance limit was equivalent to 50 per cent of a bank's holdings of such bills and, from August 7, 1987, the proportion of refinance available was increased to 75 per cent of such holdings. The interest rate on refinance under this facility was 10 per cent *per annum* (as compared with a yield of 8.5 to 9 per cent).

So far, the results of these auctions have been disappointing, largely because the terms offered have not been sufficiently attractive from the point of view of the market. Moreover, if the authorities are not prepared to accept tenders at higher rates, this is bound to inhibit the development of tender activity. For long-terms success, there must be a will to achieve results. If the size of the tender could be increased, there would be more chance of encouraging the growth of a secondary market, where — once a run of maturities has been achieved — buyers could acquire maturities suitable to their requirements. Perhaps, later on, weekly auctions might be introduced to provide smaller steps in the spread of maturities.

In due course, perhaps the authorities will also agree to a 3-months Treasury bill auction — under current circumstances, one would expect the shorter bill to atrophy — when a more realistic rate would tend to be established. As banks reaffirmed many times in interview, the administered rate was too low to excite any real interest. One would hope, too, that any secondary market that developed for the longer dated bill would in due course come to comprehend the shorter bill also. At the same time, one would wish to see lender of last resort facilities at the RBI for all Treasury bills with (say) no more than 1 month to run. Moreover, if 3-months Treasury bills could be auctioned at dates in between 6-month Treasury bill auction dates, an even better run of maturities would emerge and this should greatly encourage increased use of the secondary market.

Unfortunately, there is not much of a secondary market in government bonds. Some switches are done in search of better yields, but for the most part these represent the substitution of new government securities at higher rates for old securities that are absorbed

by the RBI and virtually disappear from the market. Switches[17] may also be done with institutions other than the RBI. Brokers come to the banks either to buy or sell; the bank will offer a rate; but there is no pure competition, no effective market. The only other "market" is the RBI; it offers to sell at a price and the bank may buy. The RBI may also offer to buy, but only what they themselves want to buy and at rates fixed by themselves.

The only real utility of government securities from a bank liquidity point of view (apart from eligibility in the SLR) is as a basis for repurchase agreements, which tend to be tailor-made and may be for periods of a single day out to 180 days (one-day RPs would tend to be on the last day of a reserve period) — 15 day RPs are quite common. RPs may be done with other banks, the specialised financial corporations, even with non-financial corporations.

It would be wrong to close our discussion of Indian money market arrangements without a reference to the foreign exchange market, where FOREX brokers operate and are important. There are about 20 active FOREX brokers in Bombay. Brokers also operate in other smaller centres such as Calcutta, Delhi, Madras, Cochin, Bangalore and Ahmedabad. The total is 50-55 operating across India (some are in more than one centre). Of these, only 10 firms are in the first category. The rest are small or medium-sized. Commissions are fixed on the basis of value[18] by the Foreign Exchange Dealers' Association of India and on the recommendation of RBI, which imposes guidelines. Competition is very active on the basis of service. There are no discounts.

The main means of communication between markets in India is by teleprinter. Markets are also linked by telex connections and brokers have direct lines to all the banks, also Reuters monitor screens.[19]

In earlier years, only the British exchange banks undertook FOREX transactions. Subsequently, Bank of India, Central Bank of India, and SBI entered the market. At end-1986, there were 69 banks

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[17] Regular switches into new securities is a means of "gradualising" the associated depreciation.

[18] Rates of commission are as follows: $ and £ — outright 0.01; short swap 0.006; long swap 0.0075. Other currencies — outright 0.0115; short swap 0.007; long swap 0.00875.

[19] The Bombay market opens at 9.10 a.m., when the RBI announces the rupee/sterling rate on the basis of which all the other rates are calculated. Operations continue until around 4.00 p.m. There is virtually no market after that except for a limited amount of activity up to 7.00 p.m. by way of purchases abroad (*e.g.* in London or New York). Some banks also deal in immigrant remittances up to 5.00 or 6.00 p.m., with banks coming in from overseas. There is no business on Saturdays, when the "back-up" work has to be done.

that had been authorised to deal in the FOREX market, of which 28 were public sector banks, 18 private sector banks, 2 were large cooperative banks, and the remainder foreign banks (British, US, Japanese and West German, also French, Dutch, Canadian and Middle East). About 90 per cent of the business done is done by Indian banks and the remaining 10 per cent by foreign banks. This is commercial business which is large. But there is also a small amount of FOREX trading — all the foreign banks are involved and about 6 big Indian commercial banks, though there are a great number of RBI restrictions and volume had come down considerably by 1986, largely because foreign markets have become both vulnerable and volatile. Communications can be difficult even in Bombay. They tend to be very good internationally. The Indian FOREX market has become increasingly sophisticated over the years since 1984 and — even though volume is restricted — dealers have developed an expertise comparable with other markets around the world. All this excludes rupee business with Communist countries; this is done on a government to government basis — settlement is also government to government. Except with Romania (which is on a hard currency basis), groups of commodities are agreed both on the import and export side, but it is all related to money — so many crores of rupees.

Before concluding our discussion of the present make-up of the Indian money market, a word should be said about the indigenous institutions. Reference has already been made to chit funds and nidhis. These are not important for the money market as such, though they do absorb funds (as does the inter-company market — see below) that might otherwise have fed into the banking system. A more obvious money market institution is the Multani shroff. Formerly, and indeed into the 1960s and early 1970s, the Multani shroff lent money to customers by discounting a hundi (which was originally in promissory note form) and then, after endorsement and by arrangement through a hundi broker, rediscounted it with a scheduled bank up to limits agreed upon; usually the Multani had limits with several banks, the most important being the SBI, the Bank of India, and the Central Bank of India, but there were others. In this way, the Multani acted as an intermediary between the joint stock banks and the small trader about whose creditworthiness the banks would not have any detailed information. In the Multani community today, hundis are not trade related; they represent finance or accommodation paper. The hundis are now drawn

in bill of exchange form[20] (though still called a hundi). Over more recent years, limits for the rediscounting of hundis were no longer available from some banks and at other banks had been greatly reduced (certainly in real terms). By the mid-1980s, Multani limits for the rediscount of hundis had completely disappeared at SBI and other public sector banks. However, the Multani shroff still operates and discounts hundis for small, medium-sized, even big traders, also for medium-sized industry. In fact, their coverage of economic activity is fairly extensive. Under an amendment to the banking law, the taking of deposits is now considerably restricted and has greatly hampered other shroffs, who continue to survive as commission agents. In accord with the new situation, the Multanis no longer accept deposits from the public — only from friends — and their trading is now based on their own capital (which they have increased by ploughing back profits, thereby offsetting the virtual withdrawal of bank finance).[21] It was maintained that the Multanis still had sufficient capital resources to continue in business and discounting hundis would remain a significant part of their business. As well as Bombay, Multanis operate in a small way in Calcutta and Madras, but do not operate at all in Delhi. Multani shroffs are also active in financing the movement to the ports of crops from up-country areas (*e.g.* in central and southern India), though the competition from the wide-ranging branch network of the public sector and other banks must over the years have eaten greatly into their business. So far the Multanis have survived as part of the indigenous sector — the amount of lending against hundis has been maintained (capital has been increased to offset the loss of rediscount limits at the banks) — but it is rare these days to meet a young Multani. Most of their sons are tending to go into the professions, or technological employment, or other form of business. One would expect therefore the Multani shroff gradually to disappear and in real terms their lending role is already tending to decline.

It remains to consider how best the Indian money market might be developed. In my judgement, the objective should be to move gradually but positively towards a freer market, *i.e.* with a steady reduction in the extent of restriction, and also towards increasingly flexible rates of interest. Further development would be greatly encouraged if a greater

[20] They are accepted by the person who owes the money, but the bill of exchange may be payable to a third party.

[21] A small amount of bank finance is still available, but it is expected that the small limits that still existed at certain banks in 1986 would soon be withdrawn altogether.

number of participants were attracted into the market and if resort were made to a wider range of money market instruments.

As compared with the money market of years ago, the Indian money market of today is hampered by a variety of restrictions imposed by the authorities and by the application of ceiling controls on interest rates. More than that — it has become very lopsided because of the presence of one major lender in the inter-bank call money market (the State Bank of India), which carries a large number of big public sector accounts. Apart from SBI being a very large bank, which has in recent years dominated the Indian banking scene, the extent to which it operates as banker for public sector accounts provides it regularly — allowing for some ebb and flow — with huge amounts of cash, whereas the majority of the other public sector banks tend to be net borrowers. One way in which to reduce this dominance would be to spread around among the other public sector banks a high proportion of these public sector moneys and thereby achieve a greater degree of balance both in banking business and in the availability of deposits and cash. It is argued that many of the large public sector accounts have been for very many years with the SBI and that for historical reasons it would be difficult to change, but there are other large banks in India, though not of the size of SBI and large public sector accounts might well henceforth be shared between several of the larger banks, with medium-sized public sector accounts going to the less large public sector banks. It is understood that this is already beginning to happen, but the process could certainly be accelerated. Better balance between banks might also be achieved by a number of mergers, such that there might be a reduction in the number of public sector banks from 28 to, say, about 8 (excluding banks in the SBI group). This may in fact make for less activity in the inter-bank market, since there would tend to be more offsetting of balances within the individual institutions, but this would be offset — in my judgement — by a better balance of business between banks. Moreover, if "black money" was reduced in quantity[22] and the inter-company market in deposits became less important, more money would flow into and through the banking system resulting in a much higher degree of integration and a consolidation of markets.

[22] "Black money" derives from what is called the "parallel economy", which itself relates to undeclared incomes that evade tax. "Black money" is thought to amount to 18 to 21 per cent of GDP, which for 1983/84 would approximate from Rs. 31,584 crores to Rs. 36,786 crores. See "Aspects of the Black Economy in India", *Report of a Study by the National Institute of Public Finance and Policy*, March 1985.

Another major inhibition to the freer operation of the money market is undoubtedly the 10 per cent ceiling on inter-bank call money rates. There have been some evasions, as has been indicated, but these are not major. One would argue, too, that the fear of excessive volatility in rates — and of excessively high rates from time to time — can be exaggerated. Extreme volatility is not the general experience in money markets and very high rates tend to be both short-lived and required only for marginal amounts of cash. However, it would be wrong to suppose that removal of the 10 per cent ceiling would of itself resolve all the problems of rigidity in interest rates. There are many other rates — on both deposits and advances — that are subject to ceilings and, if greater freedom is accepted for rates of interest, progress should be encouraged on a broad front. At the same time, in order to avoid too much disruption and as a means of nursing back to freer market conditions institutions that have been subject to many years of rate rigidity, ceilings might be raised gradually step by step as a progressive move towards their complete removal. This is what is meant by a gradual but positive movement towards freer market conditions with flexible rates.

In this context, it is pertinent to refer to the 1987 Report of the Working Group on the Money Market, the relevant Committee having been set up by the Governor of the RBI under the chairmanship of Shri N. Vaghul on September 5, 1986. There seems to have been general agreement that there should be some liberalisation of interest rates, presumably with deregulation as the ultimate objective. But Para. 3.5 of the Report would appear to have been too cautious. One could agree that "any attempt to rapidly deregulate only one segment could create adverse repercussions on other areas of regulation". Yet the Working Group seems to feel nonetheless that interest rates should initially be freed "in certain segments" and "to the extent that it does not conflict with the basic thrust of the overall economic policy". They favour pragmatic measures "rather than any preconceived bias in favour of a totally market determined interest rate structure".

The possible reintroduction of money brokers to the inter-bank call money market is more debatable. So long as there is only one major lender and the existence of a 10 per cent ceiling on rates, with the SBI (and other large lenders) only lending at 10 per cent, there really is no role for the brokers and banks on the whole prefer to deal direct with people they already know well. Nor is there any point in paying commission. Only occasionally has a bank (usually one of the smaller ones) needed assistance in establishing where funds are available. But in

a less lopsided market with flexible rates — even if the *quantum* of deals did not markedly increase — both rates and availability may be more difficult to discover and the brokers may again be seen to be capable of performing a useful role. Furthermore, if the market were to increase in size as — hopefully — the amount of black money in the economy was reduced, brokers would tend to become more necessary. Finally, any doubts about lack of professionalism could readily be overcome by requiring brokers to be "approved" or "recognised" by the authorities and, in any case, if a broker does not provide an appropriate and reliable service, his facilities are not likely to remain in demand. On balance, I would favour a resumption of money broking in India in the belief that they do provide a useful service. It is also encouraging to know that brokers of repute, who would be prepared again to undertake money broking in the inter-bank market, are still available.

In attempting to encourage the further development of a money market, early attention should be given to the possibility of increasing the number of money market instruments available. This is certainly true of the Indian money market, in order to broaden it as much as possible. Steps have already been taken in this direction by introducing a 6-months Treasury bill (in addition to retaining a 3-months Treasury bill) for which regular auctions are now being held. It is to be hoped that the amounts and regularity of these auctions for 6-months bills will be progressively increased, hopefully that a secondary market will be developed, and that the RBI will continue to provide the ultimate liquidity by sanctioning refinance facilities. It would help, too, if the 3-months Treasury bill — which could become a very useful shorter dated instrument — were also to become subject to an auction procedure. If it does not, it will remain a non-event. Its main purpose was to be bought to absorb a surplus of funds at the end of a reserve period and then to be sold to the RBI the next day. There was an artificially low rate of interest and no secondary market. With the imposition of an early rediscounting fee on 91-day bills, the 3-months bill could be killed off altogether. This would be a pity, since a 3-month bill tendered for at an auction to achieve a realistic and market-related rate would provide a valuable complementary market instrument. If this is not done, it would be best to abandon it. Faith would then have to be placed solely in the monthly auctions of the 6-months bills, which would over a period of some months provide a whole range of useful maturities including short dates (approaching maturity) — even better if auctions became fortnightly or weekly and the basis of a secondary market. It

would then only remain to provide ultimate liquidity by maintaining refinance facilities at the RBI.

Short-dated government securities (in addition to Treasury bills) are another possible instrument, but there is really no secondary market for them in India. However, an alternative already exists and this is the repurchase agreement based on goverment securities, which is also in use and which is a very flexible instrument indeed. Resort to it has in effect filled the gap that would have existed because of the poor secondary market in government securities. The problem is that RPs for longer periods — say, for 12 months — may involve the borrowing party in the risk of depreciation, particularly if rates are freed and tend to rise.

In principle, the introduction of other money market instruments would also be a good thing in providing wider scope for bank adjustments in the context of assets and liabilities management. There is already an active market in commercial bill rediscounts, with ultimate recourse to the RBI. This — it has been argued — might be further expanded by encouraging the co-acceptance of bills by bankst to increase the volume of first-class bills. "An important step that needs to be taken by the Reserve Bank is to provide the necessary guidelines to banks in regard to co-accepting of bills."[23]

Negotiable Certificates of Deposit (NCDs) are another possible instrument that might be employed, especially if it was issued at market-determined rates with guidelines set out by the RBI (*e.g.* as to minimum amount, maximum period to maturity, etc.). It is maintained that this is unlikely to be a success as long as there is a flourishing inter-company market for loans and the large-scale attraction by corporations of deposits from the public at rates of from 18 to 20 per cent. What it is necessary to realise, however, is that loans to corporations (whether by other corporations or individuals) are often highly risky (and there has already been experience of losses); also that the NCD not only permits of the investment of moneys for short periods, but — given the development of a secondary market — the disinvestment of such moneys at market rates. But for the NCD to succeed, it would need to be traded at freely determined yields and prices. Hopefully, given the quality of the paper (*i.e.* a first-class bank name), rates and yields would be competitive with other instruments, including

[23] *Report of the Committee to Review the Working of the Monetary System*, Para. 215, p. 315.

loans to corporations (particularly if considerations of risk are taken into account). To encourage a secondary market, and as a first step, one might permit for a period issuing banks to buy back their own NCDs, though more positively it would be better to permit — and to encourage — banks to invest and trade in other banks' CDs.

On the borrowing side, the leading corporations may consider the issue of commercial paper on the US model (corporation IOUs), though it is possible that the Indian money market is not yet sufficiently broad to accommodate this. It could also have adverse repercussions on bank lending to first-class risks. Moreover, for commercial paper to take off as a money market instrument, it would require at least one dealer (see below) to specialise in the issue of such paper and ideally a credit rating service.[24]

Similarly, Participation Certificates provided the banks with a convenient channel for obtaining short-term accommodation from the investment institutions, which were able to provide such accommodation during the period that intervened between their cash inflow and the disbursement of funds for capital projects. They had the advantage of being exempted from cash and liquidity reserve requirements. They could also have been traded in. They started off quite well, but did not really take off and have not been regarded as very successful.

Another possibility might be the securitisation of a range of paper — *e.g.* mortgage paper, the term loans of the banks, and the 5- to 7-year paper issued by institutions like ICICI. But such securities would only represent a useful extension of the range of instruments if appropriate secondary markets could be developed. That is a *sine qua non*.

The other major direction in which a money market might be developed and which should go together with the introduction of more instruments is an extension of the number of players. In addition to the banks and major financial institutions (like LIC, GIC, UTI, ICICI, etc.) one would hope to comprehend the merchant banks which are growing up in India and which could best be operated as subsidiaries of the parent institutions (*e.g.* SBI, ICICI, and several of the foreign banks) and which in addition to new issues, corporate advice (*e.g.* on mergers), and syndicated loans might increasingly deal in money and capital market instruments. Then there are the corporates, which could become quite important if they were to enter a secondary market for Treasury bills, also for NCDs and commercial paper, if and when markets develop in which such instruments come to be traded.

[24] See also *Report of the Working Group on the Money Market*, Chapter VI.

Finally — and all these were matters which were considered by the Working Group set up by the Governor of the RBI in September 1986 "to examine the possibilities of enlarging the scope of the money market and to recommend specific measures for evolving money market instruments" — there were those who believed that some kind of intermediary — like discount houses — might be useful as a buffer between the RBI and the other players. The recommendation of the Working Group[25] was to set up a Finance House to deal in short-term money market instruments "with the primary objective of imparting improved liquidity to these instruments". It might also act as a broker in the call money market. It was to be set up jointly with the public sector banks and financial institutions. It is understood that some of the preliminary work has already been put in hand. What would be more appropriate, however, would be the setting up of "approved dealers" to hold portfolios of Treasury bills, other short-dated government securities, short-dated commercial bills, NCDs, commercial paper (US style), etc. on the basis (say) of call money with a view to dealing in them, absorbing paper coming to the market from time to time and retailing it on other occasions to meet the short-term investment requirements of banks, specialised financial institutions, corporations and others, thereby assisting them to develop an increasing degree of sophistication in their assets and liabilities management. Certain broking firms might be invited to provide the expertise and, on the basis of capital provided by other market houses (for which precedents exist elsewhere), to set up subsidiary dealing firms, which would be supported by ultimate recourse to the RBI against approved security. Alternatively, some of the merchant banks might be prepared to undertake this work, though again with recourse to a lender of last resort. Moreover, if a complex of money markets were to emerge along these lines with a wider range of participants and a broader market comprehending a larger number of types of instruments, possibly even a market greatly expanded in volume, there would again be a strong case for restoring the money broker to his former role. And above all there would need to be a progressive and considerable improvement in communications. At the same time, it is one thing to perceive the direction that changes should take; there needs also to be a will to change.

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[25] See *Report*, Chapter VIII.