Money and Banking
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Lecture - 13

We are with topic three, and you would learn something in this topic which you may find it useful later. This has to do with the many market, and I am going to talk about Indian money market, not really other money markets. Now I gave an introduction to something called a financial system, why it exists in every country, and why it is important. Because financial system serves as how can I put it? As you can say the intermediary between two very important groups of economic agents; one hand you have the savers who have excess money left, they did not spend enough; on the other hand you have deficit units who are spending more than what they have. You take a company building a thermal power plant; do you think they have the money to build the thermal power plant from their own money? No. So, they have to go to the financial system to borrow money to get the money. So, financial system is very important.

Now, every country develops its own financial system, two broad sub systems that exist in any country you can say if you generalize is you have the money market and the capital market. But if you go into the details of the money market, and the details of the capital market you will say they are quite different across countries, alright. So, later when you would mature more with more courses in economics you can learn about the efficiency of the financial system, why financial systems are efficient, how it can be made efficient, you can get into numerous issues, very important ones. For the time being we would focus upon only money market, because this is a course title money and banking; what is the point in going into capital market. There is no mention of stock market, shares, etcetera, nothing; however, I would like to tell you a brief of some preliminary things even if I may not be teaching capital market.

The one thing that you noticed in the previous class that the system deals with money, credit and finance, three different words; I will come to the meaning of these words. Money you have seen some money a definition of money in terms of India monetary aggregates in the first topic I defined money, why money was invented, the historic process of development of money; I talked about that too, but now we are coming to actual use of money on kind of a short run basis in the economy. Credit you understand this stuff, because banks are the ones who lend out money credit, and then you have the issue of finance. This word has been added to this system, since the corporations or cooperate companies were invented, because this finance has to do with the corporate world, and the primary emphasis there is on equity finance; you can also have debt finance.

Like governments they can sell bonds which are called debentures. When company sell bonds the oldest the traditional title is debenture; they do not call bonds. Governments, semi government organizations, electricity boards, railways infrastructure, regulatory institutions can sell bonds, but when it comes to private companies selling similar things they are called debentures, and there are various types of debentures also; that you learn in a course on capital market like financial economics or something like that. Now if you look at the Indian financial system if you summarize that I give you a slide; I did not bring the slide today. You realize that the three major corners like a triangle in the financial system; number one was the first one was financial institutions, number two was financial markets, number three financial instruments like shares, bonds, debentures, etcetera, through which money changes hand from one party to another party.

All of them are equally important, because without good financial institutions markets will not run properly, and good financial instruments will not come into existence, because financial instruments are developed by the financial institution; financial instruments are developed created by the financial institutions, alright. So, they are all connected then I did not talk about financial instruments because this topic would cover a lot of money market instruments this topic. Now financial markets you saw as I have told you money and capital market and both of them can have them organized and unorganized sector developed in particularly in a country like India. In India the money market unorganized money market is quite large, but unorganized capital market is also there. Then you have primary and secondary markets. Every market has a primary section and secondary section; basic difference is in the primary market like any goods, fresh goods are sold. Secondary market means second hand goods are sold used.

So, I bought a share today; I do not like it, I can sell it tomorrow goes to the secondary market. Stock exchanging this is very interesting which I reported on a daily basis across countries to kind of tell you how the economy is doing or the stock market is doing.

Amazingly that is not a primary market data; that is all a very much a secondary market data. Stock exchanges are secondary market data's. They are all old shares bought and sold, bought and sold, alright. Now if you go into the financial institutions there also we will study a few in the next topic money market institutions. You have the intermediary and the non-intermediary type which are the two main groups of institution. The intermediaries are who intermediates between the savers and the investors like banks. We have surplus savings, we go to the bank keep them, bank give the loan to the firms, classic example of intermediary institution, but banking institutions are just not the only intermediary institutions in India.

We have non-banking institutions who also does an intermediary job like non-banking institutions like IDBI, ICICI, infrastructure development companies who give out loans for development, etcetera, but also they collect themselves money to sell of bonds etcetera [FL]; that means they are collecting the savings of the economy directly. So, when you have that option you can either go put your money in the bank or go and buy the bonds. They are serving as intermediary between you and the investor not via bank but via them. So, you have non-intermediary non-banking intermediary institutions remember that not many but there are, and there are pure non-intermediary non-banking institutions pure non-intermediary who do not go to the markets to get funds. They are directly funded either by the government in India or RBI.

The example is NABARD, the example is state financial corporation's, the example is subsidiary of IDBI, SIDBI which you have one on campus, examples, there are many examples, and these non-intermediary group of financial institutions; one is the intermediary which are of two types. The non-intermediary group has been I used to know that as, oh, I forgot to tell you a classic non-banking example in India, classic example of non-banking intermediary institution massive; I forgot to tell you the name LIC. There is a story it goes; if the stock market is not doing well inform LIC it has so much cash every day. It can just walk into stock market depending upon what you want to do. You want to buy shares, share prices are going down; it can just lift the share prices, but just if it starts buying shares. That amount of cash it handles everyday massive that it can go and change the direction of stock prices in Bombay stock market or any other stock market in India.

There is couple of stock markets a few Bombay stock exchange is the most famous, then you have national stock exchange, etcetera. It has so much cash, because every day with their policies they sell the premium comes that cash, that cheque. So, I forgot to tell you about LIC; I am trying to give you examples of IDBI, ICICI [FL]. So, in non-banking intermediary institution LIC is the largest in India [FL] non-intermediary institutions. Now when I started reading up on this material a few years back, I came across a term called development finance institutions DFI. The development finance institutions are essentially funded by an external organization a institution like government RBI, world bank, IMF, Asian development bank and helps in the development of a country, and they take up specific tasks, heavy industry development, medium scale industrial development, small industries develop SIDBI, small industries development.

SIDBI is what small industries development bank of India. It is on our campus not developing industries helping you out with these technological improvements, etcetera, that you may do patent, etcetera, but what it is? It is small industries development bank of India created by IDBI the father, the parent company, industrial development bank of India which was created by RBI and government of India. So, I used to learn I used to hear about development finance institutions which develops a particular area of the economy, famous development finance institution in India, famous EXIM bank, have you heard of EXIM bank? Export import bank, DFI that is a DFI [FL]. Now in professor Bhole's book and on RBI site I found RBI has started using a different language a title for them.

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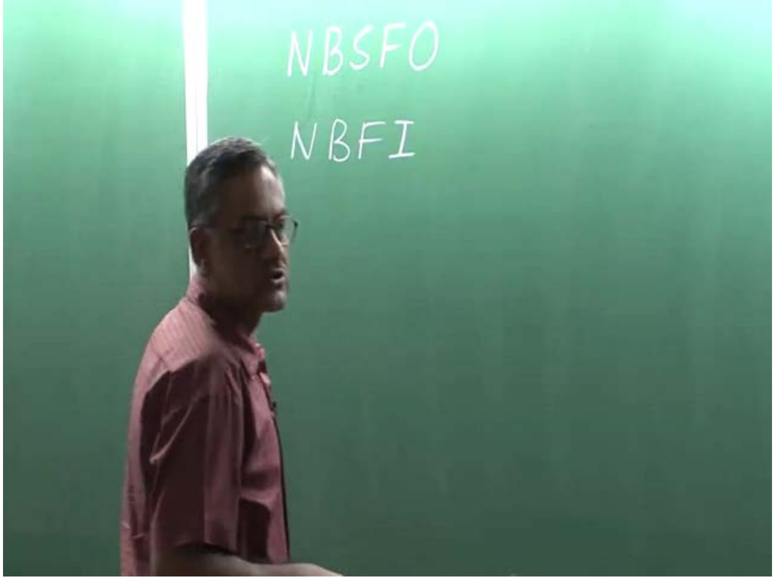

They are calling them NBSFO; let me write it, they are calling them NBSFO. I do not know why their name changes? They keep on changing things. NBSFO non-banking statutory financial organizations [FL] DFI [FL] development finance. There is some distinction between DFI and NBSFO. I have not figured that out yet, and the other group they are calling RBI the old name, NBFI non-banking financial institutions. Non-banking financial institutions if you change that to non-banking financial intermediaries not institution intermediaries then you can see the group I am talking about. One is the non-bank intermediaries, one is the non-bank statutory financial which are not intermediaries which I use to call DFI which in your slide that day I said there are non-intermediaries.

So, if you talk about non-banking institutions in a country there are two types. One is the intermediary type, RBI may be using NBFI for them these days, but we used to call them intermediary institutions. Anyway forget about it within non-banks [FL] DFI development finance institutions, RBI has given them a new title; they call them non-banking statutory financial organization NBSFO [FL] careful. So, do not get confused when you start reading the book.

Now I will not talk about these non-banks any type because that would be enormous, because when once I drew the tree for a slide like the one I showed you yesterday for non-banks, and I could not type in all the titles all the types there in one slide [FL] particularly NBSFO [FL] I could not just put them there.

Infrastructure development something and you know EXIM export import bank [FL], IDBI, ICICI, [FL] private sector, public sector [FL], many, many are there. So, I just could not put them. So, I do not want to touch that unless at the end of the course there is time I can take up a few, and you might be interested what do they do like the GIC companies you know there are four of them. What are the four names of the GIC companies? T v [FL] add [FL] new India assurance, [FL] four companies are there. [FL] new India assurance [FL], national insurance company [FL], government nationalize them put them together [FL]; we will talk about that later a general knowledge thing. You know why GIC is different form LIC, right. You know GIC is different from LIC; tomorrow you get a job in Bangalore first thing you do when you get a flat and buy things, go to a GIC company government of India companies anyone around and buy a policy to secure your goods, office [FL] [FL].

Get the insurance for your goods, your music system, your clothes, your washing machine, your fridge, this is GIC, and LIC is life insurance, you understand that; that is the basic difference. We have two very well developed insurance markets in India [FL]. I need not go into that is again another kind of you know the theory and all that are quite specialized. Now after financial institutions after I talk about the intermediate which RBI is calling NBSFO these days, then I mentioned if you would look at the table if you have with you regulatory institutions. Now I think there were two regulatory institutions with respect to the financial markets in India or at least two major one's; there may be minor one's I am not sure. RBI for money market and SEBI for capital market securities and exchange board of India, two regulatory institutions; I will not talk about SEBI, but I will definitely talk about RBI.

Now there is the final tree ends with a branch last branch end of the last branch of the institutions other I have written. This other have became very important; the other group has become very important. You have here credit rating agencies I told you the hospitals for companies, go to the hospital get a health check up; come back with a report and your employer wants to see the report, what is your blood pressure, what is your sugar level, how is your eye sight, alright, etcetera, etcetera. Credit rating agencies have became important worldwide, even they rate countries these days' international credit rating agencies like standard and poor; have you heard of standard and poor? On t v you will see standard and poor is a credit rating organization which these days rates countries, and when they publish a report positive or a negative result internationally Delhi [FL] opposition [FL] if it is negative view opposition [FL] India [FL], and the ruling party goes in to a defensive mode. No, no, no, it is not that bad may be they are saying it, but you would not believe me how influential, how important they have become in the just last 10 years, 10, 15 years for India.

You would not believe me; it was not there at all, because I lived through these years unfortunately with these economics, etcetera, and newspapers I could you know see something; it has become so important some organization as standard and poor, etcetera. The credit rating agencies are essentially they give you, you would not believe me like a grade triple A, open CNN, the other day they were showing the credit rating of the central bank and the countries like Spain, Italy, Greece, and how they are downgrading them. They have credit downgraded of Germany also recently unbelievable; the strongest nation in euro they have grounded it, downgraded it, because of all these trouble going elsewhere Germany is facing the wrath joint family [FL] family [FL] problem [FL] financial drain and all that that takes place [FL]. So, European Union is nothing but a joint family system very simple terms in monetary union; unfortunately, it is not a physical union they would have less trouble; anyway that keeps on going on.

They are companies certified by the central bank, depends if it is operating in European union it will be euro bank, if it is operating in India it will be Indian bank, Indian credit rating agencies are like CRISIL C R I S I L; what authority does IMF have to talk about India? That kind of a question you are asking me, ignore, ignore, that is what politicians say if you do not like it. What authority does IMF have? Does India have any loan from IMF now? It used to have, then it had an authority because it made sure that the loan is utilized properly and returned. India does not have any outstanding loan with IMG but also what authority does IMF; that kind of a question is an open ended question, but credit rating organizations, these organizations have created status for themselves like that. They are accepted in by most countries; yeah, yeah, because it is backed by central governments or central banks of various countries, it acquires.

If I get a knowledge and USA recognizes me, Germany recognizes me, immediately my market value goes up; that is it very simple, but if you talk like politicians there is a negative result who cares it is a foreign institution, how much do they know about India? If you argue on that line I rather keep quiet; yes, okay maybe, but the point is they accept it. But a credit rating agency is like a non-bank; it does not do banking activities, it does something else, and I put them other because they have no financial kind of a dealing that way in that sense, alright. Now these standard and poor, etcetera, they are not only credit, they are multiple activity institutions now; they do various kinds of things.

Now these institutions come into existence in India via RBI permission just like banks. Bank you want a registration to be done; I want to open a bank, you have to get a registration. It will be given by RBI; territory organizations are also created by RBI in some sense are permitted not created permitted. Permission has to come; you want to open a private company private limited, public limited. You have to go to the company board and obtain the registration a license like thing; otherwise, you would not be able to operate, okay. Even private small cooperative societies require licenses. I will talk about cooperative systems later; that also I have a little bit very interesting [FL].

Now in India these other institutions one of the most famous one for our case, money market, money bank, money and banking course is called DFHI. DFHI this has become very important. DFHI is discount and finance house of India; I will talk about that later. Discount and finance house of India DFHI has become very important, then you have these credit rating organizations; there are millions many other organizations. Now I have talked about the primary market and the secondary market. I am coming to the markets, instruments I will take up in details. We talk about the primary market and the secondary market; you know that in a bond market the risks are less, because the bond always issued by somebody whose name is written and it says it promises to pay you a return interesting coupon rate or whatever.

The problem is if we if you go to money market uncertainties are there, risks are there not so much, but if you go to the capital market there is a lot of risk. Now since I would be talking about money market in details if I can keep aside money market right now and talk about the capital market, there is a name for the capital market which is called the securities market. Now the word security means both shares and bond slash debentures.

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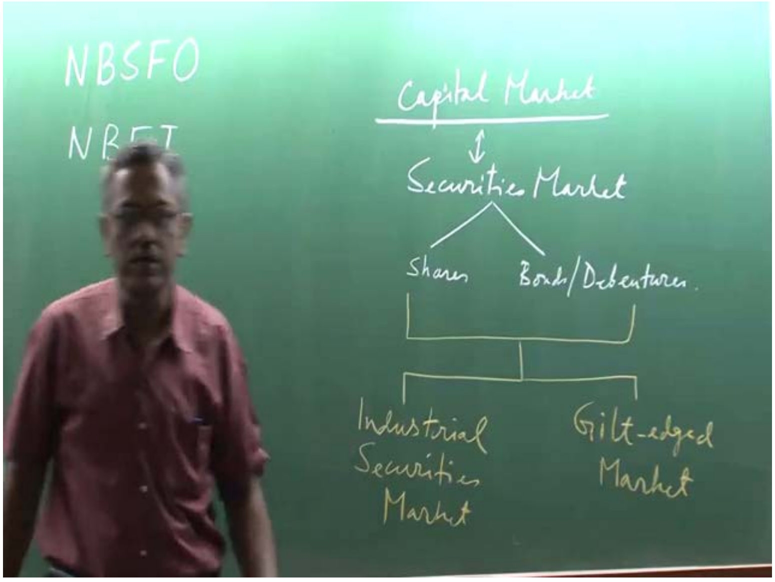

This capital market has another name called securities market, and this securities market means they are dealing with both; remember security means both shares and bonds slash debentures, alright [FL]. Now these days we call it capital market; earlier days they were called probably securities market old name [FL]. Now what I want to tell you I mean these are the things you come across. These securities market again has two kinds of groups. This is a conceptual group; it has nothing to do with a location like a market does not have a location, market can be anywhere. You can talk about the Indian apple market. So, the apple is not sold just in Delhi or Kanpur; apple is sold all over the place we have to consider everything.

So, this has one name called industrial securities market; industrial securities market where you are talking about the private sector only industrial securities market private sector [FL]. They may be selling shares, bonds, debentures, whatever, private sector. Another part side of the securities market you have the gilt-edged market. It is also part of the securities market or a type of securities market. The gilt-edged market basically means gilt edged means if you open dictionary risk free. So, what are you talking about then here? An amazing securities market where whatever is sold is risk free, what is it then, who operates in that market; when it is risk free who operates? If it is risk free gilt-edged market means risk free. So, who operates there? See industrial securities market is a private sector market.

What do you see in the Bombay stock market happening, etcetera, the numbers; they refer to industrial securities market, but at gilt-edged market what does it mean? Risk free government securities market; government can sell all kinds of things, treasury bills, government dated securities which are also bonds, various kinds of things government can sell [FL]. It is okay to ask any question; do not hesitate to ask me any question. Sometimes I may stop you, because I am in the middle of something then I will halt and then answer you. So, gilt-edged market essentially means risk free market, because the other market is extremely risky; you do not know what is going to happen to share prices tomorrow, alright.

Now you will find in the money market as well as here that there are various kinds of risks involved, and there is various kinds or various degree of risks involved, and we need not go into it. I am talking about here all risky stuff and here zero risk stuff; that is all, but you can go into the gradation of risks later. In money market it also happens [FL]. Now another important thing that comes up often is and risks as you know you will learn that in financial institution. The higher the risk higher the return often is assumed; the higher the risk may be the lower the degree of liquidity may be often instrument, quickly you cannot sell it. It is very risky; people would not be hesitating to buy that.

So, you can find associations of risk return liquidity, and you can get into very complex situations, and you can have mathematical models dealing with them. In fact, they do that. Some of the projects I am supervising now one of them is looking into that probably what has he or she said I forgotten fifth year MSC economics projects. So, they are interesting; economics students get every interested in that. MBA department offer a number of courses very important ones, but I do not know whether you get admission there registration there or not.

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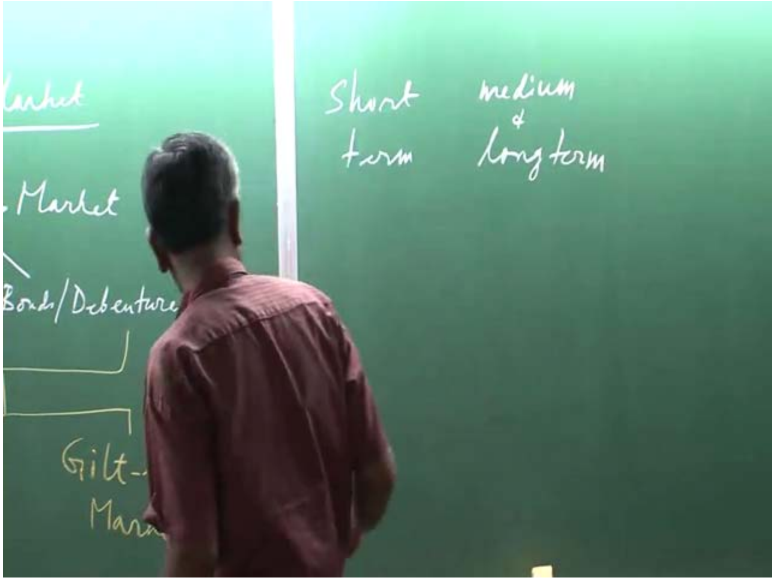

Then I want to talk about a very confusing area in this literature is short term and medium and long term; they make a distinction. Short term in macroeconomics you know that it happens and medium and long term together; they make a distinction between these two, short term, medium and long term. Short term is a typical feature of the money market that you will study short term, and the short term is defined something which has a maturity of equal to or less than one year and money market is full of instruments which are short term. So, many people prefer to call the money market the short term financial market, and the capital market, the medium and long term finical market can call that. Now you go to more than one year stuff an insurance matures or bond or whatever shares are many years. Then you get into more the capital market, medium and long term in the financial market; typically you will see that.

You do not see very short term instruments in the capital market, never. Money market they are full of them, and you do not see very long term one's either. Now when you go to the capital market switches completely, this is another thing which you should remember, and usually the medium term is between 1 to 3 or 5 years and more than 5 years they called it long term. I am not so sure about it, but this seems to be the practice more than 1 year, but less than 3 or 5 years is medium term, and more than 3 or 5 years is long term instruments. One to three is roughly the medium term, more than three is long term; this is what they do [FL].

Now before I come to a description of the money market which I want to do I am just setting up the platform for it so that you know these things. I have already talked about the primary and the secondary markets. Every market has a primary and secondary market. Whenever there is a primary market they have certain institutions functioning whenever there are the secondary markets in any market, money market or capital market, there are certain institutions functioning. Secondary market typically you will find the dealers and the brokers functioning middleman, [FL] share [FL] bond job [FL]. At the time transaction is over he keeps a commission called a service fee and goes.

What happens in the property market a lot abroad particularly; in India it is also developing. The realtor they call real estate agents. Real estate agents essentially intermediates between the buyer and the seller of a house or a property or a land secondary market, but typically these middleman operates, middle organizations called brokers and dealers. Money market oh yeah, capital market particularly. The primary market [FL] what you have is something very different; its role is very different. They are called primary market operators who make the markets function; they are called underwriters.

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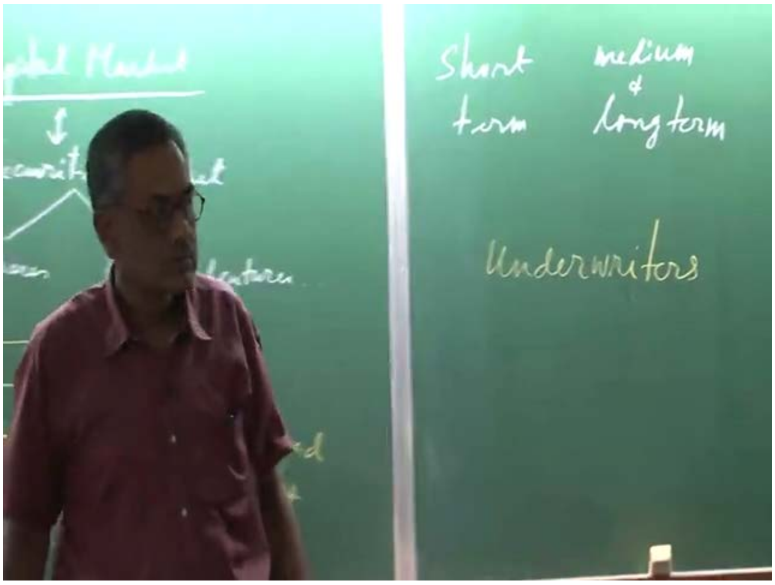

Underwriters, it is like you want to file a case in the court what do you do? You file a case in the court hand it to [FL] case [FL] fee [FL] against [FL] fight [FL]. What do you do? You get in touch with a lawyer; companies want to sell shares, they get in touch with underwriters. Then they sell shares, and there is a comet of legal obligations, newspaper may announce [FL] structure [FL] booklet [FL] which is called IPO initial public offer. How much worse amount is a public limited or private limited company who can buy at what price will there be share. In a big company advertisement IPO advertisement I have seen on newspaper, there are at least five or six underwriters; that means there is a big guy who is fighting a case is so complex and mammoth that there are five lawyers who are working for him.

Five or six underwriters involved with a company when they are going for an IPO big company like Tata steel going for an IPO. There will be you know mammoth size. It has an international offer also probably, it has a domestic offer or shares, and there are four, five underwriters involved. Now how would you know sir [FL] underwriters [FL]. An underwriter actually accompanies [FL] which we called these job today's language, this underwriting job what will be the legal issues, how that brochure would be written up you know initial public offer the literature, what kind of permissions are required, credit rating agencies, certificates are required. The gamut of it, the company just gives the money to another company called underwriter, who does the job. It does not get into that, and it depends how good the lawyer is the better that function the system functions. Now many of you will get job tomorrow in these companies. So, you will say sir [FL] underwriting job [FL] complex [FL].

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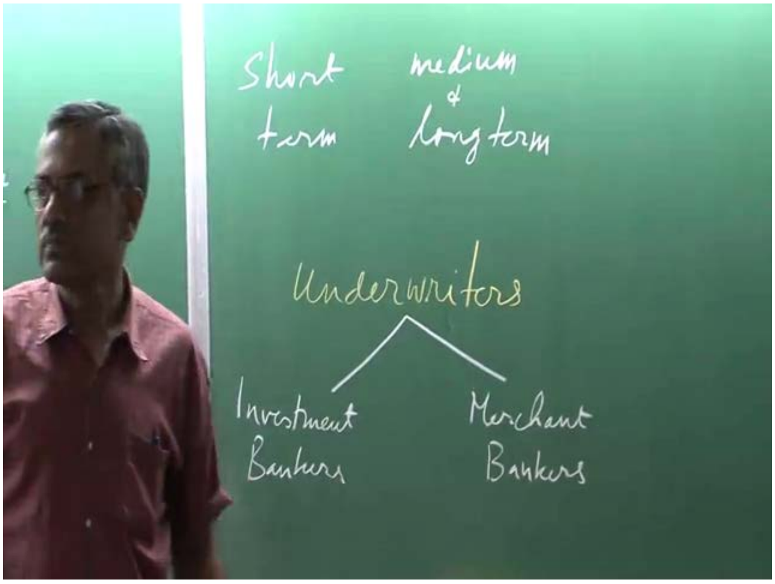

This underwriting job is now I have taken up two names in the world; these companies are called two names. In US they are called investment bankers, in Europe and particularly England they are called merchant bankers. They are not commercial bankers, bank word [FL] non-bank institution [FL]; they are called investment bankers and merchant bankers. So, these are called banks amazing companies they are non-banks; they are not commercial banks, they do all these kind of things. So, this is an important information; I am giving you many people know probably in class but some of you do not know. So, I am giving that to you.

But when you come to the secondary market complication [FL] individual share [FL]company [FL] issue [FL] company selling shares [FL] amount [FL] broker or dealer[fl] daily wage [FL]. Some of the brokers and dealers are big; they have established themselves big, even so big that this one guy called Jhunjhunwala is on TV often discussions. This fellow is nothing but a broker in the Bombay stock market, but his company has become so big, and if you look at him you would know that he is earning a lot because his weight is nearly 300 kg. He is making a lot of money and getting fat and this person is also on t v; I am not joking, but he is a famous broker. So, some of them are very big, but you have a host of very small players there [FL]. When it comes to secondary market the personality completely changes of the capital market or the money market, and in money market also you have underwriters today.

Government of India wants to sell treasury bills; earlier RBI used to do that, but these days they go to the underwriters, and money market underwriters have a name in India today. They are called primary dealers; I will talk about that later. Money market underwriters they have a famous name now typical name they are called primary dealers. [FL] money market [FL] complex [FL], capital market [FL] share market [FL] immensely complex. It is alright if I kind of tell you one more point just one more point when an underwriter takes a job it also takes the responsive of selling a minimum public subscription, minimum public subscription MPS. When he takes the job of selling your companies share the company tells the underwriter and the underwriter gets in agreement that minimum this amount has to be sold; otherwise, no share will be sold.

Maximum has an upper limit, but there is a minimum limit also, they specify minimum public subscription. Company A is selling shares one lakh minimum public subscription is 10 percent of that which is 10000. If 10000 shares are not sold it will be called back, nothing will be sold. So, often there is a minimum that has to be sold, and underwriters have to make sure that it passes the test that the minimum is sold [FL] underwriter [FL] India [FL] company [FL]. So, there are all sorts of things. I am not really giving you anything, I am just floating above the iceberg and touching it and telling you this is what you see here. If you go into it, it is enormous, massive, a whole area opens up. So, my job now is to get to details of money market instruments; it is coming up tomorrow.