Money and Banking
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Lecture - 20

Topic one, topic two and up to c d market. Repo market is a essentially a secondary market for securities, where funds, exchange again securities. And the funny thing is there are various motivations which are at work in the repo market. Why banks, primarily banks involved? The why they are repo transactions, repo is essentially a transaction today with a commitment or agreement about something in future. So, it has forward kind of a market personality of character, forward markets are you agree something which will happen in future. So, we too agree that we would do this in future today we agree upon that.

Forwards market are very common, exchange rate may forward market (( )) share market may forward market (( )). Repo market is a forward market in the sense that you agree to do something today with an agreement about something also in future, which will happen. That future thing is that if I am selling securities to you, I am doing it temporarily not permanently I will call it back tomorrow on a specify date. So, it has the forward agreement. So, repo is repurchase; repo means repurchase agreement; repurchase which is that agreement that will take place in future.

Very different from secondary typical markets for any securities, because secondary market is no agreement about buying it back in future. I sell it mean, I sold my car, I sold my shares means, I sold my bonds anything - it can go to you, and tomorrow you can sell it to somebody else. There is no agreement that I will buy it back again from you. So, this market is different, secondary market very different secondary market that the motivations have various high various things have motivated, motivate the repo market.

In fact, in India we have two at least two repo market one under LAF, forward RBI. LAF is liquidity adjustment facility of RBI I will explain that at the next topic this. This let us started beginning of this century RBI started this. LAF - liquidity adjustment facility where essentially RBI as the central bank or the head of the money market, upper heads through the repo market the kind of monitory policy, it has nothing to do so much with facilitating banks cash requirement. It has, but it essentially does a monitory policy like thing. Like the municipal authorities do kind of services provide for cities. If there is excess rainfall, they make arrangements for the rainwater to drain out, which they do miserably that fail most of the time; and if there is a drought, they should make water available. So, this kind of a money supply, there is shortage RBI makes sure there is an enough liquidity in the market. If this too much liquidity RBI has to make sure they have to drain out the excess liquidity which has been a case I will show you the data.

On the when I started teaching this course in 2008, first time I taught it for this MSC students - third year MSC students, first batch. When I looked at the data, I could not believe that bulk of the transaction in the repo market are the reverse repo, 90 percent transactions more than 90 percent were reverse repo transaction in a particular year. What does it mean? It meant that there is excess liquidity in the system which RBI is continuously draining out. So, RBI s point of view that LAF segment of repo on which I have data is essentially a monitory policy and monitory policy or repo is the monitory policy instrument, then you have to remember that there are other monitory policy instrument which also RBI use this. So, it is in a package, in a basket of RBI. Other ones I mentioned CRR open market operations and a traditional monitory policy instrument in other countries which we do not use much, because RBI does not traditionally does not use it, have not used it in India is called the bank rate.

Now, what is bank rate, it is kind of an interest rate. I will explain that again in the next topic. So, the bank rate, if you look at the other countries, European countries first world countries even second world countries or third world countries bank rate are often important, but not in India. In India, CRR, open market operations, repo these are important. Now, is that all that the repo market no there is a market segment of repo on which I do not have data we are banks interact with banks and non banks etcetera. And there the repo transactions are essentially from the point of view of a banks liquidity requirements. It has nothing to do with monitory policy, because bank individually do not operate monitory policy, RBI operates that.

So, if the banks requirements, banks SLR requirements require they are require to show some securities which they do not have and they do a kind of patch work there are what they do, they go to another bank, do you have securities, they say yes, ok take this cash and give that to me for two weeks, two months. I have to show the SLR, I do not have securities; that means, I have hadn’t I haven’t had cash which I could have invested in securities which I could show in my SLR. So, do you have securities and they are particular type of securities also. SLR does not allow RBI any security, they specify what kind of securities. These are the things that you would learn and your understanding of this entire money market will be more complete when I go to the next topic. I take up RBI in details.

So, they go for a SLR requirements then they for CRR, they ask for cash, they sells securities to get the cash, they have to show the cash every week with a fort night scab. So, two weeks back the Friday, the position I had in with respect to deposits, I have to show the CRR today with the RBI, not show it actually keep it. So, from banks point of view the motivation is very different and therefore, there is the market repo on which I do not have data. I have data only on the RBI side from, the RBI side which is on the RBI s LAF repo, which is monitory policy.

Now, earlier, there was some trouble and then the stops some securities in the 90, early 90s, there was a scam and then they brought back all securities. Today treasury bills government dated securities, C p, C d s they are all allowed in the UTI units, they are all allowed in the repo market to be used their securities; it is a very open market. But when LAF auctions are held regarding repo by RBI they are held by RBI, they do not allow non banks to come in they allow only banks. And some primary dealers like DFHI etcetera they allow, and STCI - securities and trading corporation of India, there are some organizations institutions.

Non-banks, I may take up at the end of the course; I will prepare some notes for you on non-banks, which I do not have in the topic list which may interest you. So, they are not the few primary dealers and you know we are allowed along with the banks in LAF non banks are not allowed to participate, but they may they change things also from time to time. The liquidity adjustment facility and LAF started 5th June 2000, I have the note date exact date here also, I will talk about that. And the market segment as I told you that they do not have RBI does not publish the data etcetera. And the idea about repo being I why RBI is so active with the repo market there idea is if you look at the money market which is a short term market, now banks funding banks liquidity, how you are helping you have developed the call market. Then you have this surplus cash to be invested in the treasury bills market, which you have made very competitive, because you have 91 day, 182 day, 364 day, 14 day [FL] not there.

Now, you are also allowing the repo transactions; two kinds one is the market repo and in addition to that LAF repo. So, what is happening the short-term money market is becoming very competitive. Now, according micro theory or economics theory, if a market becomes more competitive, prices should come down and prices should near each other, even if it is differentiated market. Even in case of the differentiated market, where you have different products being sold in the market like the car market or the refrigerator market the AC market and you name consumer consumers durables, competition may not be perfect competitions, which will learn in micro theory may be monopolistic competitions may be oligopolistic competitions. But competition does over all one thing they through competitions the price come down, excess price the monopoly prices do not remain there so much.

So, price is come down and product quality is improve also, because they are competing and price also come closer to each other. So, there is not much of a difference between products sometimes in term of prices. So, in a particular car segment market if it is very competitive, you will see that prices are quite different, you will have a difficulty in selecting a Ford product and the Hyundai product and the Maruti product, where the cars are very similar the designs may be different that is why they say differentiated market. Now, what has happened is that the these active participation of the RBI in the money market, particularly where banks are operating as made it very competitive, but I have found the treasury bill market also has become very competitive.

I will show you the yield to maturity, there have a very close to each other unbelievable. A one-year treasury bill and a 182 day treasury bill, and three month on treasury bill 91, all have yield maturity very similar very interesting. So, they are becoming competitive and the price is also come close to each other. So, these is one of the thing they are trying to do and which I have found in professor (( )) book RBI language probably professor (( )) quoted it at one one chapter, I think in the call market chapter or somewhere in the repo chapter, where repo has been discussed. Is that they are trying to create an interest rate corridor, short-term interest corridor. Corridor means a passage long passage through which people travel walk back and forth.

So, they are trying to create a corridor within which has a boundary walls within which the interest rates are going to move they may have short term fluctuation variances, but they are within a limit within a corridor and i tried to plot the data and find out whether the interest rate corridor is there or not. So, you can see that data you can check that yourself which RBI attempts that attempted to do or RBI still tries to do. And professor (( )) book has mentioned that language phrase interest rate corridor. So, we have to see that was they are trying to essentially make the market very competitive short term money demands. So, this is about the repo.

Now, repo is international definition of repo is injection of funds. So, the interest rate RBI is asking under LAF when you injecting funds. And reverse repo is when RBI is allowing the banks to park the surplus funds with them that is the reverse repo. In some ways, as if RBI is borrowing from them actually RBI is by borrowing means RBI is helping out the banks [FL]. So you would expect therefore the reverse repo rate will be low then the repo rate, because repo rate is when banks are asking for loans, RBI charges a higher interest rate and when RBI is helping the banks to park their surplus cash with itself give it to me, I will go down to give the your stuff and even you will kept and interest on that and that rate is lower. So, the reverse repo rate is lower and the repo rate is higher this is what you will see in the data, I will bring the data out.

Student: Sir, this transaction are made through securities finance (())

Professor: Yeah.

Student: So, when the securities being sold at that after whatever the final amount is pay after let pay you the interest rate (( ))

Professor: I have not understood your question.

Student: Sir, for example, a bank has give it excess cash to RBI. So, what wound the bank dos by RBI securities for just (( ))

Professor: No against securities RBI is giving securities.

Student: Sir, now with RBI take back the security, will he pay as per the amount that has been created after (( )).

Professor: Market, it is they called it market determine because this rate is decided through an auction, RBI agents, people and the banks etcetera, who are participating in the repo market. They sit together and there is an auction and the discount rate is decided there, both the repo and the reverse repo. And since they are not dictated by RBI they called it market, but not a purely market, because there are other participants who often are non bidders just like treasury bills who will have to accept the rate. So, the bidding is allowed only buyers selective group of participants. So, it is market not purely free market, market to some extend as suppose to RBI pre fixing it. RBI could have said this is the interest rate [FL] that is not the case, they negotiate through auction. So, that is and senses the market. But there is a market repo, when no RBI is there, where banks interact with banks and non banks in the repo market. That data I do not have that is the pure market segment of repo and this LAF segment, they call it market determined repo and reverse repo rates, where auction have held clear [FL].

Now, I come to it is good news I come to the last, but very important point. This I have been studying since I was in college and I was we were given some English books where in England this concept first developed, and there are famous economist who wrote books and discussed this issues. And I wonder what is the relevance to India because I do not get anything about India, finally when I got something about India is all very negative.

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It is still very negative about India, but this thing is very important without talking about it, I cannot close money market. This is called commercial bills. So, I have to talk about it. So, only after I have talked about it that I can close this topic. Commercial bill market, I have to talk about often it is referred to as the bill market. I tell you it used to be so boring, but the books had great books some of the books may be in library. If you want to know about the English system, how it is started, I read about England the bill market in England Sayers one famous author used to be when I was a college student like you first year second year student. What are Sayers - s a y e r s. Sayers book was famous on banking wonderfully written very well written English author. Now, a commercial bill, like you know, in case of C p C d I used a term like (( )) promissory note.

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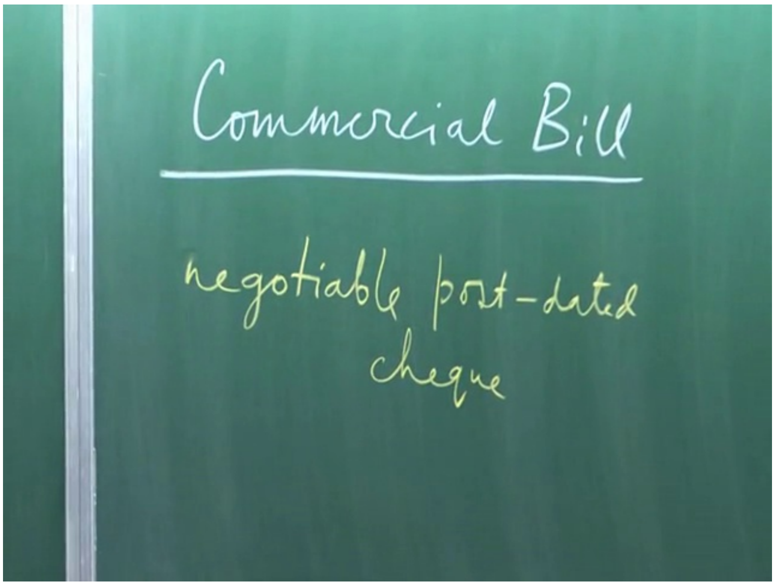

In case of commercial bill, there is a term that is used to describe it, it is called negotiable post dated cheque, term is used negotiable post dated cheque. This is it more our system will get organized Indian system, Indian markets etcetera, the more you will have the commercial bill market acquiring importance. But the commercial bill market has not acquired much importance in India so far because our money market if you look at its so, much of that, even the entire economy, so much of that is un organized market and there is huge black money thing there.

Some people used to say it is about 40, 50 percent of a GDP. And so much of unorganized sector that the commercial bill market really could not develop much. So, what is this c v a negotiable posted a cheque. It is very simple why and you will also understand and appreciate probably why it is important. The entire business world, the economy where the economy lies the market world works on the basis of a few features like trust future payments, borrowing they are based on that. So, I will produce some goods I have to do so much before finally, I can produce a goods and production itself can take time, sometimes some I ten six months to produce or two months or one month to produce.

Now, what I have to do. I have to arrange for the raw materials I have to first have the plant and have to have the raw materials then the labor. And then have the production plan have a future output, target and produce determine the prices, find the markets where to sell them. So, it is a lot of world, that is why not many people wishes to become an entrepreneur because it is just so much work and easy to go and work for somebody get a salary at the end of a month come home [FL] forget about the rest. Otherwise, if you are a entrepreneur, you have so much headache everything you have to take care off.

Sometimes for a new company the entrepreneur does not have much helping hands. In a established company, the entrepreneur is supported by you know all kinds people he can hire, he can had a CEO, he can he the board of directors, can have the managing directors, the other specialist around who then do the work, but where its be new you have to do the work. What is happening here is that when you buying the raw material from the raw materials supplier, you are yet to earn enough revenue or you have sure something where the revenue has not come. Because the agreement there has been six months later, they will pay. But you going to stop your work here, you are going to stop production here, so you have to keep on paying the worker's wages, the overhead fixed cost, the electricity bill, water charges, other rents, the raw materials supplier you have supply.

Now, what happens is that often these other then the essential once like the raw materials supply, you may also get into some sort of in loan kind of a system where you buy the goods, but you do not pay it today you promise to pay later. Now, therefore, the trust becomes very important. Therefore, it becomes very important that when you are not paying him, when he has sold something to you and that may be locate in two different cities one is in Madras, one is in Kanpur; they do not know each other that well these they are not neighbors. They did not grow up together going to same school they have never seen each other. Now, so there these agreements are required where post dates cheques are, cheques play an important role.

That I do not pay you know I right can write a cheque, but you will get the payment six months later or two months later. Therefore, the question of trust comes whether I would sells at all to this fellow in Kanpur, because I would not get the payment today. So, because of this nature of business where things do not happen right away it is often based on borrowing, future payments, forward contracts a repo you have just seen. This kind of institutionalize system which you have, it is important that banks play a role where banks can stand a guarantor for that seller saying do not worry do not worry I know this buyer I know his financial standing. So, if you sells good, it would not be defaulted and worst come worst, I am going to keep some assets of this fellow, so that if he defaults I will pay you that amount.

So, now you are going to get into various complex negotiated deals agreements where goods have changed hands from the seller to the buyer who is also a producer may be of course, but the payments have not been made. There were commercial bills come, they are nothing, but negotiable posted a cheques. So, the two parties have to negotiate you will pay me one month later, but one month later that I have to wait you just cannot pay me the price that I have shown which you could have paid if you at which you would pay, if you pay today. But if you pay one month later you will have to pay more, because I have to wait out one more month.

So, they agreeing to like a legal agreement like going to a court on stamp paper, there are stamp papers available from court on which conformably agree in the presence of lawyers etcetera with proper signatures and documents that this is the bill that we create. So that they can go into very formal negotiated deal, where both the parties agree when the payment will done and that is how a commercial bill comes into existence. And it is essential to the functioning of the business world. But the more the business world is in the underground, the less we know about these commercial bills, the less commercial bills are supported by the banks because the banks belong to the organize world. If the banks belongs to the organize world they do not have much confident to support the commercial bills of the unorganized market. So, the bill market is just not developing in India, still not developing in India will I am assuring that. So, it is a very important topic I started today, I will go very slowly there are various kinds of commercial bills and very interesting also, to me it is very interesting also.

Now, so commercial bills have posted a cheques, negotiable everybody and then agreement basically between seller of good and a buyer of goods. Now, suppose the seller is A and the buyer is B, and B has declare I cannot make the payment today, I do not have cash I will make the payment six months later. A then draws a bill that is writing a bill, which B has to agree. A then draws a bill stating the amount that B is required to pay on a given date at specific date will be mentioned; B then will acknowledge the bill by counter a signing or whatever, his obligation to pay the written amount. A who has sold the goods would drew the bill who wrote the bill and make B who is the buyer of the goods to agree to that acknowledge that A is called the drawer of the bill and b is called the drawee of the bill.

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So, two parties have formal names the drawer of the bill and the drawee of the bill, and the drawee of the bill. The guy who is suppose to make the payment in future, and the guy who sold the goods did not get the payment the poor fellow there. So, he has to go through, but he has to run his business too. He cannot say I will only sell goods to he probably cannot have the freedom, he does not have the freedom to say, I will sell goods only who can make make me payment today of course, that will be the first preference is just the present discounted value concept coming here. Since he will make a payment in future and today is more attractive then future; in future if he has to wait you will have to pay more to make it equally attractive. Present discounted value again coming here, because this guy what he will pay six months later, the present discounted value would be smaller today. The interest rate taking coming into the pictures therefore, the commercial bills do carry an interest cost that he has to made to wait.

Throughout money market, you will find the existence of interest rate whatever be the context. Same thing present discounted value stuff coming here [FL] today's is more valuable then tomorrow. But tomorrow you have to do to make it valuable, I have to add more monitory terms to it or whatever value to it [FL].

Now, drawer and drawee a once this is very interesting now. Now, look what game starts. Once the bill has been acknowledge by both the parties and it is a proper commercial bill, and a smart guy will make it acceptable in the eyes of law make it legal with proper documents etcetera. Now, A suddenly has wings flying. In a proper commercial world, he even does not wait six months what he does he goes to the bank and cashes it. He says here is the commercial bills, I sold this goods to him seller in Kanpur, company- x, and he says yes we know the company bank has to know. He will make this amount of payment later, but if you give me cash today you can have this amount of income because I will ask you give you discount on it. So, the bank purchases at the discount, banks waits out till maturity and cashes in finally, by recovering the money from that buyer in Kanpur, the drawee six months later and makes an income.

So, this fellow actually what he does, he draws the bill and he can even benefit, because the price he may extract from the bank is higher than he is getting the cash today. Higher than what he would have got he would have receive if the buyers of those goods have made the payment right away. So, part of the interest he recovers immediately and makes an extra the benefits and you can see this justifies the existence of commercial bills. Because if there is a commercial bills situation and both the parties can trust each other they benefit, and the intermediate who was nowhere in the picture probably, suddenly finds a windfall gift, or Tata consultancy [FL]. Who would miss trust buy the bill, buy the bill immediately bank makes a profit. So, this is the whole range of rewards system make it survive the commercial bill very interesting.

Now, if your parents are in business, ask them about commercial bill if they know. So, now he can go to the banks sell it bills. So, secondary market is immediately created; secondary market, he sells it off bank waits out till the bill will mature and then finally, change them out that maturity get the money, and bank goes back happy home goes back home with that money in its pocket [FL]. Now, having told you about this basic concept of commercial bill what I have to do, I will have to tell you about various kinds of commercial bills that exist. Before I tell you, I will tell you an story about in India where commercial bills are mostly found not in the organize market, export import market [FL] not in the organize market. So, international commercial bills are created also internationally. But our bulk of the commercial bills are in the corners in the pockets of the origin of the Indian industry which is the wholesale market, this and that the trading communities, where which started god knows 100 years, 150 years back. And the commercial bills are operating that you do not believe me, the commercial bills are working they which I hardly any legal document [FL] often if you go to wholesale market, you will see there is a clip and some small size papers and it looks like a small pad, it is not actually tad loose sheets.

And we do not have a habit of writing cash memos, and we bought something, they will write something on it may be a date is mentioned not even a signature, not even a rubber stamp of the shop there, forget about the company not even a rubber stamp of the shop. Something is written this is you have bought this amount and a date is given that is the cash memo that they give us I have seen that happening. Commercial bills in our economies often traditionally created like that on a piece of paper. And how does it function, because when it comes we are on this shop we may be with a rubber stamp now, because it is a commercial bill and payment will made in future they all exist and co existed for years, centuries [FL].

They know each other very well within that close domain commercial bills are operating all the time and those days no mistrust. So, if foreign expert, expert looks at this commercial bills of Indian wholesale market, trading community, etcetera business community commercial, they would get extreme surprise cannot believe probably commercial because to them commercial bills are very formal document. It is like a legal paper, it is like a you know you can take it to a court and get it is accepted by the judge would look at it. But here commercial bills only a piece of paper with a rubber stamp [fl]. So, it is unbelievable how the Indian economy and you know something, so strong people trust the business community would trust that method of the creating commercial bills and that kind of commercial bills, they would not be any problem.

However in formal; however, shabby; however, untidy it may look; however, incomplete it may look like a commercial proper in comparison to a proper commercial bill, there is no problem with the business community. They live with that they have they have seen that from the childhood this commercial bills. Often future payments have made. So, in the market or being the producer and the market and the producer is there got knows for how many years they supplying it. And the wholesaler who first purchase the product have no lack of confidents there. So, a simple commercial bill like that will easily work.