Money and Banking
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Lecture - 33

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Now, I have begun. What I begin is what I have been trying to do. In this course, we talk about the conventional money and banking syllabus what we have in India and then combine it with applied kind of economics; when, how, monitory policy is operating or operates in that. We will continue both that is what I have the data to see how the money market has been behaving in.

Now, yesterday I abruptly stopped when I started talking about LAF. So, what is LAF? It is liquidity adjustment facility, whose adjustment is RBI initiating the adjustment of liquidity in the monitory system is essentially consisting of what they have in mind is banks. It is of course, is a role for non banks, we should not have any reputation.

So, banks require cash banks give out loans on the basis of repo. Then, this is the mismatch of supply of funds, demands of funds. So, there is a liquidity problem. Sometimes supply is more, sometimes demand is more. So, liquidity adjustment facility program of the reserve bank of India, essentially repo market ILF had 4 items in the basket saw that, but LAF operates primarily or only on the basis of repo and the reverse repo instruments.

So, what is repo? Let us let us recall what the repo is. Repo is when there is shortage of liquidity in the system, the system I am talking about say banking system, and then RBI would inject funds. They can do that in alternative ways. Also, they do that which is medium term instruments. They use like CRR or open market operations, but very short term liquidity transmits day to day basis, sometimes twice a day, twice a day, they do with the repo market

Of course, it is a market thing here where RBI does not come into picture, but except for some rule for one of the primary dealers of RBI primary dealers of RBI are essentially settled at organizations RBIs created, which can perform some of the functions with respect to the money market on behalf of the RBI. So, RBI did not get involved the entire prime directly. Here, primary dealers they have created, they are like kind of profit making organizations, which are revenue, which has a cost sign. They do business the way a business you need as business.

Now, with the help of RBI, somewhat autonomous units like IIT, IIT Kanpur, IIT madras or IIT Bombay are autonomous institute. After all, they are holding company ministry of ministry of developed a major, but they function on a day today basis IIT deals with. That does not make a does not have many correction with a majority. So, these primary dealers do the job. Now, the very short term, it just had been l n f thing. So, they are very short term money market instruments in India. They use the way they are used essentially with the repo market through the repo market.

Remember also one of thing, there is a repo market also in existence, which is the market repo. RBI does not come into the picture mans within themselves operate the repo market the way they operate the call market. I have no data on that repo market. I heard about it, no information on RBI side and even DFHI call market information is not there even on RBI. I say I have no, I look for it call market is with the market call or market data is same, but the DFHI portion is not there.

Now, this day to day mismatch in liquidity imbalance, the liquidity is managed through RBI. So, if there is a shortage, it could announce a repo auction. They are done through auctioning. So, they would invert the middles and who does that? I think the primary jobs are done by the primary dealers. These are the main what you call the money market underwriters, money market underwriters. RBI directly does not get involved much. I think they do the job through primary dealers. These organizations they have created in the share market.

For instance, you have the underwriters for primary shares and the brokers and the dealers for the secondary shares etcetera. Here, these primary dealers are doing all that job the brokers and dealers job and underwriting job. It operates through the repo and the top repo report. Now, this is really market determine repo sometimes because it is still not purely market determine because RBI would announce the repo announce the repo and reverse repo like a monitory policy instrument like RBI would announce. The CRR values will be now going to remain for few months and days, if got a year or more than a year will remain.

So, determine in the sense, it would look up what the liquidity situation is at. What kind of monitory policy they want to pursue, whether a relaxed monitory policy, which is called expansionary or a tight monitory policy, which is called contractionary, it put please send the repo reins. When they change, they announce it, even they have come somebody from RBI, they announce. They are called new monitory policy beginning Monday 21st or what 22nd of October, new monitory policy.

I heard that there is a monitory policy coming of end of October after they are going to announce the new monitory policy. I got that on t v. So, this is what they have been doing. Therefore, the repo market has become very short, so short that it is just like call market very short term daily rates hour to hour called in France. Sometimes repo auctions you have seen data 50, 40 times among. how can it be on the day, how can the number be total number of options in among 50 total amount of days can be 30, utmost 31 minus holidays.

So, it has to be more than 1 auction a day. This is what I told you when I show the repo data. Now, let me give you an idea about material. So, LAF had a basket of instruments. LAF has only the repo market to operate with which it operates liquidity is just for facility is very short term very short term. Now, let me tell you about primary dealers. These are the organizations I am mentioning. I talk about often DFHI.

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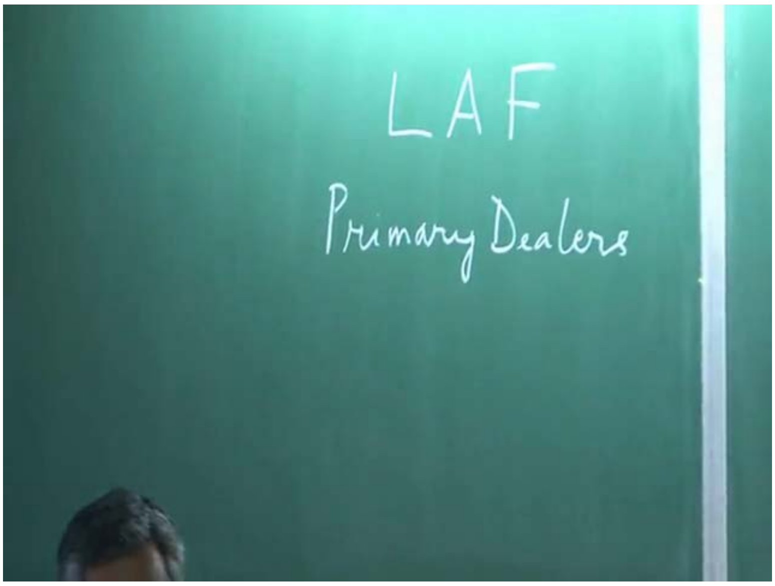

So, primary dealers are monitory intermediaries, essentially like brokers. They also do the under writing job when new share government shares like government bonds are sold etcetera government dated securities. They began their operation in 1996. So, you can see the 1990s was a reform they created a lot of ago 1996, which is nearly the end of that Man Mohan Singh finance minister Narasimha Rao prime minister nearly end. This is because its end direction was in 1997; I think no direction was in 1996, it is nearly around that time the end of that period.

Essentially, the objective is to support the government borrowing program. Government borrows money by selling government dated securities, open market operations and also treasury bills resembles. I can buy from primary dealer. We have to just locate a primary dealer like a shop. We have looked it whether big bazaar is and go to big bazaar and buy.

So, it is a government borrowing program and of course, strengthens a securities market infrastructure. This is because if you have well defined, well functioning intermediary dealers, then the market functions more efficiently, we do not have to run around and etcetera. You know well things are available and of course, the liquidity issue is always there. Primary details have an important job since they operate in the money market. They have to look upon the liquidity aspect.

So, they should be carrying a stop car in the government securities for the repo transactions. They should carry some amount of cash to use in the repo market or whatever and what are the primary dealers operate, you know at least one operates in the call market DFHI. It has even its own rate compared to the market call rate, which is interbank call rate. So, private dealers have been in action other in 2003, there was a famous FRBM act, 2003 FRBM act. I am just not going to crowd your mind with too many actions.

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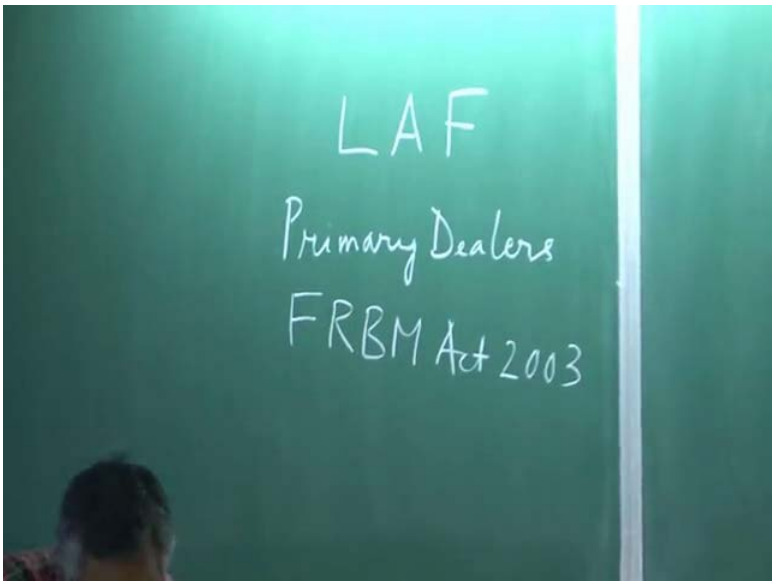

I am just mentioning as a general knowledge thing. This is a very important one FRBM act 2003. The fiscal responsibility and budget management act is where by reserve bank very important. Why I am telling whereby reserve bank of India was prohibited was born for participating in the primary market, money market effective first April 2006. Imagine earlier, it is to be reserve bank of India doing the entire job and that famous thing they use to have this amount of money this amount of money.

Therefore, they are selling. So, what is there to buy and then that what you what I call that that what is the term? I used to forget the term forget the term. I will be checking that devolvement issue was there. Therefore, RBI will have to buy it as and of course, RBI in a month. So, deficit financing, when you collect cash from the system, you are not injecting fresh ones. So, you have got a problem of deficit financing. If you have devolvement issue RBI and RBI cannot be carrying whole lot of extra cash, all the time is not a business unity in the sense. So, it will have to print the money, which has the right to do so.

This is very important fiscal responsibility and budget management act 2003. RBI gets 3 or 3 years a time. So, first of April 2006, RBI is no longer going to operate in the primary market, the selling of bills of government on behalf of the government. Then, collecting cash primary is no longer RBI responsibility. So, it is, slowly government is trying to discipline itself RBI; of course, has been studying government rules.

So, the question is whether government listens to it or not. Now, you can see there was an initiative taken like the earlier one, you saw with respect to head office they completely stopped. They replace with ways and means advances for short term advances government requires from the RBI with an interest at an interest cost.

So, there has always being this kind of a thing though what happen that after they sat when RBI was stopped who would do the job. There DFHI was one institute and a few primary dealers that is where there was an internal group of the RBI, they always have an internal group like forming a committee here equal area. Sometimes, we also have a practice or putting student representatives form to look into some issues.

So, these are called eternal committees of the RBI working groups in general committees, etcetera, where they decided. Now, to open this primary dealership permission, technically license would be given to banks. Banks can open a subsidiary like bank will allow running mutual funds, which are risky business not part of the normal banking operations, but as of a function of a subsidiary, you have to open a subsidiary which is not use in public money as deposit money to do that for, but can run mutual funds.

So, SBI and CANARA bank can something, it was can something the famous mutual funds team. They had though various commercial banks had through a subsidiary. Now, what they are saying is that often these acts etcetera when RBI was stop from function in the primary market or government securities, essentially they said now who is going to do the job. We are going to make create more primary dealers. How you are going to create it?

Well, banks that are flushed with funds has surplus funds etcetera profits etcetera. You will have them with a corpus. They can create a subsidiary you did, which does not to drop a banking operation primary dealers just a mutual funds this they have created.

So, this is how to open market operations etcetera would be carried out from the onwards and no RBI business. RBI side carries the data of RBI side would carry the data repo reverse repo until I have scheme. The job is done by the primary dealers. So, I have a little bit old notes. I am sorry. I am looking for the data.

This data is often little in a 1 sentence, 2 sentences in the 1 of the reports is very difficult. To locate that, I am trying to locate through a p d f file. You know it go for a search and you locate that in their annual reports. How many annual reports you can go up and look for it to give a search? Then, it colors that those works or whatever I the entire text 1000 page text, you have to look for where the information lies.

A few years old information, I will give you. They were 17 primary dealers that created by the UPA first government, which ended in 2009. Around that time up to that 0.87, 17 on which 11 are standalone primary dealers. Standalone means they are registered, licensed and registered as a company, which you and me or somebody has created as a primary dealer, standalone primary dealers and some and 6 are subsidiaries of banks, primary dealers, bank subsidiaries may be the numbers or not more, I do not have exact number.

Now, this internal group, they said about primary dealer's activities. I do not know whether whether I will be able to know. I will try to show you some data today. I missed the class, half a class yesterday. Let me give an idea about how the business is done by the primary dealers, essentially they are not under I think commitment. Now, they will have to do the job government wants to collect money, borrow money. The government announces that information goes either by RBI or directly to the primary dealers. Then, primary dealers how they would operate?

The underwriting commitment of a primary dealer or of primary dealers is divided into 2 parts, underwriting commitment. Underwrite means the responsibility you take to sell something. Essentially, it means under writing a share for a company flows new shares, the responsibility take to sell the shares. So, company sells dispersion of capital. So, this was what what will the, what will expect the market price is going to be how many shares should be sold capital.

Therefore, I will have who takes the responsibility of the company gives under writing you have 2, 3, 4 under writers. So, the under writing commitment of primary dealers, since then since 2006, after RBI operations were stopped in the permeable market, there are 2 parts. They are minimum underwriting commitment and additional and additional competitive underwriting.

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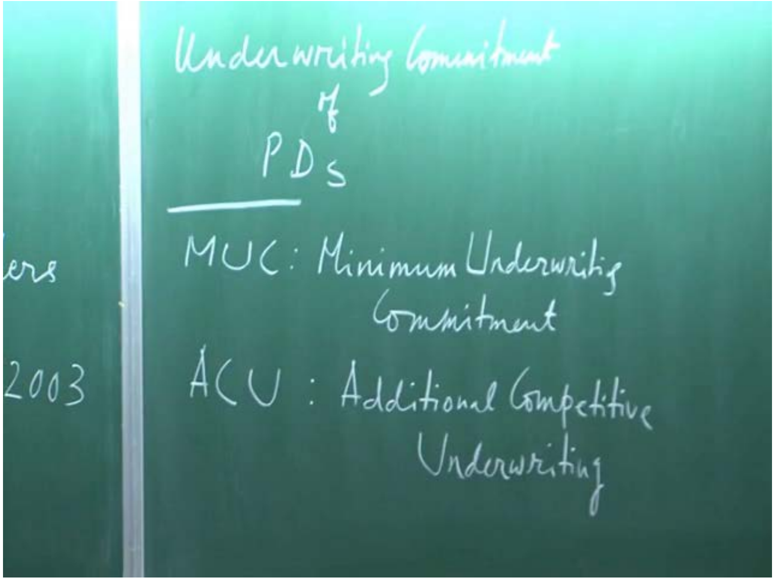

The under writing commitment of PDS, primary dealers is as follows, MUC, minimum underwriting commitment and ACU, additional competitive underwriting additional competitive underwriting. Now, this that I was showing you, I have seen an uncomfortable little bit. Let me tell you still that I have in my notes, MUC of each PD, each primary dealer around that times 17 PDs stuff when it was was at least, it would ensure that at least 50 percent of each issue is covered by the aggregate amount of MUC of PDs at least 50 percent is covered. So, it is a commitment. You have to buy PDs will have to buy yourself government is announcing an amount of set of government bonds treasury bills or whatever to get cash.

Now, MUC means minimum underwriting commitment. If there are 17 PDs, they should cover at least 50 percent of the total value. That means each under that each PD will have to buy at least of 3 percent when I told you 3 into 17, 51 percent done. So, it is 49 percent remaining. This is the minimum underwriting commitment. Each PD will have to buy 3 percent of the amount that has been declared by the government that they want to sell and therefore, get money from the system 3 into 7 in 51 percent, 49 percent per hour.

The MUC is uniform for all PDs irrespective of their capital or balance sheet size. So, given that, there are 17 PDs. Each PD required underwriting about 3 percent how the notified amount of each option as MUC notified amount of each option as MUC. The remaining portion of the notified amount is to open to competitive under writing through auction. So, there are no auctions there.

In fact, first no auction is there. The remaining portion as will be auction who wants to buy hours for the n percent remains some with your banks some PDs are all sitting there. Who wants to buy each PD? Therefore, required to be in the s c u for a minimum of 3 percent and not more than 30 percent, there they put a limit.

Now, PDs, they think they will always be willing to buy. Therefore, the minimum of 3 percent each can buy a massive. If they really like this thing, the the the the thing that government is selling maximum, they can buy of 30 percent. So, there is no combustion there. Why these kinds of a willing process are there? They are found they are they are being able to sell entire government amount whatever government puts.

So, the minimum under writing commitment requires every PD to subscribe 3 percent of the divide amount. Then, they can go and buy. If they want, they can buy a minimum of 3; not less than that. If they really like, they can go up to maximum 30. Suppose that somebody a purchase 30 that means about 49 minus 30 is 19 percent remains. 19 percent can be picked up by 1 or 2 more PDs.

So, all PDs, they are not involved in the ACU, additional competitive under writing competitive in the sense not price competitive. Suppose that in the repo market, we saw the price competition going on is a competition in terms of amount. You buy quantity competition going on. Remember in competition in micro economics or economics is often explained in terms of price competition what price you charge.

Therefore, what price I charge that is kind of a competition here and other kind of competition that goes on in industrial economics and micro economics quality competition. What features you offer? What features in my car is there and we compute with each other. But, here they are talking about the amount, you want to buy. The food is served.

So, they are competing. I have seen in marriage wedding reception, I do not know. It happens here in wedding receptions, I have seen that couples of people are just competing and to have so how much they can eat over few items. Have you ever heard of this; probably not. It is a joke you think. Isn't it? I have literally seen you know they are competing. They do not like big. They are pretty thin guys, but the amount they can eat and of course, there will be a shortage after that.

This is because nobody expects who cooks. So, this is how it went. This is primary dealers. Finally, I end it looks like amount. We have to show you data. Thursday, I want to talk about the little bit about discount and finance India. This is because I have been referring to that quite frequently discount and finance also being used. So, the last thing that I want to talk is about discount and finance.

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The last lecture, part of the lecture is the discount and finance also being DFHI discount and finance also being used. This is the one I am going to talk about. This minimum underwriting commitment regional competitive underwriting, I hope you have understood what the PD has been doing at least around 2007. I exactly do not know whether the number has changed and some numbers are changed here because I do not have the latest 2011, 2012 data on this.

Now, let me talk about the discount and finance also of India, which are the oldest primary dealers. The most important primary dealer, which are RBI created, I think they created this for various purposes. One of them was the bill market. Another one was the call market.

Now, let me give you an idea. As you know that the banks are always managing cash, there is an inflow of cash. There is an outflow of cash. Therefore, they are all day long banks are dealing with cash. Then, there are this headache of SLR and CRR for which they require extra cash just for their own business. We will listen to the rules and regulations for SLR. They have to have cash and gold and un encumbered securities etcetera and current account deposits with other banks. You have seen that SLR, they have to show that entire 490 basis in CRR is weekly.

Now, therefore, banks also require discounting and rediscounting facility, only discounting facilities. Discounting will be like I got some bills, document bills. Now, I need cash. I go to RBI and say discount them and give me cash that means can put a rebounding against the cash. What is then discounting? Suppose that I have a commercial bill, which I bought under discount from the buyer and a seller of goods commercial bill where the bill will be paid later, 3 months later which is already bought under discount.

Now, I take it to some another bank for RBI and rediscount it. That is rediscount already. It has been rediscounted when I purchased and now it is getting rediscounted now as CRR, SLR. I have already mentioned. Therefore, this is we have a very much democracy or parliament system is very much interesting. We got independence from the British. What we adopted many of the systems, one of the oldest systems that are still functioning in India around the line of line of the British of a British system, you know in Indian administer itself.

In the pre independence year, it is to be known as Indian civil service, which copies the British civil service system. Later, the names changed to Indian administer system, the IAS officers. Once it got extended, now we have high higher offices revenue offices looks after customs etcetera. We have Indian railway service, here Indian foreign service here IFS and another IFS, here Indian forest service various kinds they got, but the basic mode was copied from the British.

Now, in our monitory system and various other cases in democracy, for instance, democratic systems will have the parliament etcetera is very much in the British. There are 2 ways of models in parliamentary democracy or whatever or in democratic democratic countries, parliament democracy and presidential model. Presidential model is for instance investment model parliament. You want that. We follow the British.

Another thing is that if we have been following is that money market system for instance is that the bill market existence of a discount house, which is carrying cash and willing to discount bills security cash. You do not have to go to the central bank all that time. You do not have to go for another bank or another institution.

So, discount and finance also we knew when it was created is essentially this kind of a stuff existed and facilitates money market transactions in the British economy. It is the right hand of the u k discount in finance house, they have many houses. Probably, they are right hand of central bank, central bank typically what they do? They are the intermediaries. So, the central banks also get involved intermediaries are doing the job in the money market.

Now, traditional in Indian, there are lots of non banks institutions. They have merchant banking activities like IDBI and NABARDS. RBI often helps them out with loans and advances with they use to do a lot earlier. Therefore, the facilities in India in the developing countries have gone beyond discounting. That banks who are institutions who require cash that go for a discount terms, but in India, we require always something more than a discount. We require something like a funding agency.

So, RBI is job earlier was 2 types. One is the traditional discounting, which is the English model kind of thing, money market kind of thing helping out. Another one is directly funding, creation of institutions, directly funding rural credit, directly funding industrial development through another institution like IDBI in case of industrial development, NABARD in case of rural.

So, the problem in India was the discounted finance of India, which was created. Why it would be created? First of all because we require more than discounting facilities just not temporary lending, we require funding organizations. Suppose that at IIT, IIT require some cash temporarily borrows the money over bank, but IIT requires funding to develop the laps either by bank either you require the government or somewhat you do it. Sometimes poor countries go to international institutions world bank.

So, what was happening is that India has been thinking about developing a discount and finance house of India to help the money market. But, they always had the day that there are big roles that have to be given with discount and finance also make manage. So, RBI almost always involved there was a early 70s, there was a thinking that the Indian economy, when I was a student, I remember in early 70s, there were recommending to set up a discount and finance of India.

They renew something in India. British may have left, but when I walked around, I looked at the English language that my teachers, my parents, my good classmates once wrote in the books. They would read. The higher education they will get there was a tremendous interaction with the British or borrowing from the British. Now, thinks are reversed.

There is a lot of American influence. In my childhood days, they ruled here for 200 years. They may have physically left, but they left behind, which you still find. So, there was a thinking going on about setting about discount and finance also of India from 60s and early 70s. Then, in 1979, there was a famous working group of the RBI called the core groups c h o r e shore or core. I do not think you would be pronouncing this name shore. Anyway, the core will be spelt out as the details of a discount and finance house of India.

It was only in 1988, which is the seventh plan. We studied all these. In the previous course, only 1988 that the discount and finance house of India was set up discount and finance house of India limited. It was called neither public limited nor private limited government of India committee. Government of India companies has no p v t or p u b in it. Private corporate, the purpose let the companies share holding companies will have you see p v t or p u b.

If you look of this companies, you miss you only l t d. There the 100 percent share belongs to this. This is another third type of l t d companies. It is very interesting, where the 100 percent is essential. It is government owned company. 100 percent share belongs to the government. These companies are now sometimes going through these investment policies. Government is selling of their shares some of their shares to other companies, private companies to workers to management. This is the disinvestment program going on India.

Earlier, it was an entirely government owned company. Earlier, it is going through of this investment. So, government is taking a chance. It is not 100 percent module 100 percent government. So, this l t d company was set up as a company with paid up capital of 200 crores. What is paid of capital? I explain that to you the amount of shears that it can sell to collect money from the share holders.

So, the paid up capital is announced in the constitution treated, if the company had a paid a capital of 200 crores. Now, who borrow the paid up capital of DFHI, the paid up capital DFHI was with the RBI, 28 public sector banks. 28 those days is 20 public sectors banks where 21 public sectors banks plus 7 subsidiaries of SBI. Some non banks financial institutions may be LIC may IDBI, they contributed to the paid up capital in the ratio 5 is to 3 is to 2.

So, RBI would be given half of the paid up capital. 28 public sector banks will give three tenth of the paid up capital. Non banks will be given one fifth of the paid up capital. They moved some up to the entire paid up capital that the discount and finance house of India had of 200 crores. 200 crores are nothing today paid up capital look at the amount of this kind of figures that come out.

This is because of scam and all that lakhs of crores. They talk about and imagine those days when 200 crores was a big amount. You are setting up a national institute, which will operate as a primary dealer intermediary cum this underwriter in the money market with only 200 crores. In India, small companies starting out to the paid up can be 200 rupees. Imagine the dimension change in numbers that have taken place in India. 200 crores is nothing. 200 crores means compared to an institution like a bank, which deals with cash nonbank, it is not a very large amount for a company.

It is a very big amount, may be a medium scale company and all large scale company, not a small scale, medium scale or the large sale company may have a big capital of 200 crores rules. Finance institution setting up dimension of money has changed enormously. In India, this is unbelievable. We talk of 1000s of crores these days, only 1000s of crores the lakhs of crores sometimes, when the number is very big not crores anymore. So, in addition to 200 crores, I will get our finance facility from the RBI of 100 crores, RBI hundred crores.

Also, some additional refinance if required, they can get from the public sector banks, but you know those days public sector banks, only a few of them were making surpluses, the profits. The state bank of India may be may be find or 3, 4, more, most of them where running at loss. Those days if you want refinance from a bank, I do not know, you got it except for state bank that may be in 1 or 2 more banks.

Already, you are saying banks together. Today, the ratio 5 is to 3 is 2, but 5 ratio is 5 over 10 is RBI 3 over 10 is banks together 28 pounds in the banks and 2 over 10 is the non banks. So, this is how it is set up. So, where did DFHI go? DFHI is not a developmental organization. It is going to look after their liquidity system. It is a primary dealer.

If I started working in call markets, Treasury bill market commercial bills market, which is very much. So, in England, commercial bill market is heavily heavily depended upon England up on the discount and furnace house or houses. Then, it deals with government dated securities that means open market operations, they got involved. Earlier, I am talking about this discount. Finance house RBI started thinking about primary dealers.

In the 1990s, I told you the discount and finance house of India was thought to the main primary dealer, when the main commercial bank in India is which one all are commercial banks. It is one of the apex commercial bank state banks. So, in India, we have system. The main primarily dealer, this was the guy. This is the institution. This discount and finance house of India and this is how they started operating.

So, you have to picture about the institutions in India, like money market institution. You can write few of this in some background. You know the LAF system. We have a very important money market policy institution operated by the RBI. It is actually executed now conceptualized by the government under RBI. It is executed by the primary dealer. It is like education policies are conceptualized by government.

Now, it is implemented by engineering education in India from the government point of view are engineering colleges ones at the state level at the national level they are the IITs. Do you understand what I am saying? So, this is probably because of implementing them or executing them. So, the last topic what would topic remains, but I want to show you some data. It is very interesting. Now, how much time remains; only 5 more minutes. So, it looks like not a good day for data as usual because yesterday I missed. So, I miscalculated, but how many slides? I have 22 slides.

So I will take this data business. I will take the data business. Come please on Thursday. It is very important class. I will show you the data not very complicated. I will show you the data, CRR, open market operations of these critical years in India loans advances. I will show you that power point. Now, it is that have over from over now. What is the meaning of the fire? Unleash the fire. Unleash the fire is a dangerous stuff.