respective figures are assets of more than rupees four thousand crores or turnover more than rupees twelve thousand crores, and assets of more than two billion US dollars or turnover more than six billion US dollars.

Any acquisition of control over an enterprise by a person who has already direct or indirect control over another enterprise engaged in production or marketing of similar or identical or substitutable goods or service which results in the enterprises jointly having assets of the value of more than rupees one thousand crores or turnover more than rupees three thousand crores in India; or assets of the value of more than five hundred million US dollars or turnover more than fifteen hundred million US dollars in India or outside India. When a group of enterprises is involved, the respective figures are assets of more than rupees four thousand crores or turnover more than rupees twelve thousand crores, and assets of more than two billion US dollars or turnover more than six billion US dollars.

Section 6 of the Competition Act declares void any combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India.

Subject to the above provision, any person or enterprise proposing to enter into a combination, may, at his or its option, give notice to the Competition Commission, disclosing the details of the proposed combination, as prescribed in the Act.

Where the Commission is of the opinion that any combination does not, or is not likely to, have an appreciable adverse effect on competition, it shall, by order, approve that combination.

Where the Commission is of the opinion that the combination has, or is likely to have, an appreciable adverse effect on competition, it shall direct that the combination shall not take effect.

Where the Commission is of the opinion that the combination has, or is likely to have, an appreciable adverse effect on competition but such adverse effect can be eliminated by suitable modification to such combination, it may propose appropriate modification to the combination, to the parties to such combination. The parties, who accept the modification proposed by the Commission shall carry out such modification within the period specified by the Commission. If the parties to the combination, who have accepted the modification fail to carry out the modification within the period specified by the Commission, such combination shall be deemed to have an appreciable adverse effect on competition and the Commission shall deal with such combination in accordance with the provisions of this Act.

If the parties to the combination do not accept the modification proposed by the Commission, such parties may, within thirty working days of the modification proposed by the Commission, submit amendment to the modification proposed by the Commission under that sub-section. If the Commission agrees with the amendment submitted by the parties, it shall, by order, approve the combination. If the Commission does not accept the amendment submitted, then, the parties shall be allowed a further period of thirty working days within which such parties shall accept the modification proposed by the Commission. If the parties fail to accept the modification proposed by the Commission within the specified time, the combination shall be deemed to have an appreciable adverse effect on competition and be dealt with in accordance with the provisions of this Act.

The provisions of Section 6 shall not apply to share subscription or financing facility or any acquisition, by a public financial institution, foreign institutional investor, bank or venture capital fund, pursuant to any covenant of a loan agreement or investment agreement.

Power to exempt

The Central Government is empowered to exempt from the application of this Act, or any provision thereof, and for such period as it may specify:

(a) any class of enterprises if such exemption is necessary in the interest of security of the State or public interest;

(b) any practice or agreement arising out of and in accordance with any obligation assumed by India under any treaty, agreement or convention with any other country or countries;

(c) any enterprise which performs a sovereign function on behalf of the Central Government or a State Government, provided that in case an enterprise is engaged in any activity including the activity relatable to the sovereign functions of the Government, the Central Government may grant exemption only in respect of activity relatable to the sovereign functions.

TABLE 20.1 : FOSTERING COMPETITION

MRTP Act, 1969	*New Competition Law*
Based on the pre-reforms scenario	Based on the post-reforms scenario
Based on size as a factor	Based on structure as a factor
Competition offences implicit, not defined	Competition offences are explicit and defined
[illegible]	[illegible]
[illegible] principles	4 *per se* offences; all the rest subject to rule of reason
Frowns upon dominance	Frowns upon abuse of dominance
Registration of agreements compulsory	No requirement of registration of agreements
No combinations regulation	Combinations regulated beyond a high threshold limit
[illegible] appointed by the government	TRCCI selected by a collegium
No competition advocacy role for the CCI	TRCCI has competition advocacy role
No penalties for offences	Penalties for offences
Unfair trade practices covered	Unfair trade practices omitted
Very little administrative and financial autonomy for CCI	Relatively more autonomy for the TRCCI

Courtesy: S Chakravarthy, "Competition law: Not a foe", *The Economic Times*, 21 August 2001.

SUMMARY

The economic liberalisation has increased the need for and relevance of competition policy and law because while the liberalisation unleashes competitive forces, in the absence of safeguards, this may also provide scope for unfair competition, like powerful competitors crushing small firms through unfair means, collusion, and M&As detrimental to competition. Further, there may still be some government policies like reservation for small business, trade restrictions, cross subsidisation, preferences in government procurements etc. which hamper competition.

Competition policy refers to the government policy designed to ensure contestability and fair competition by removing/preventing factors and forces that tend to distort fair competition.

The main objective of competition laws is to preserve and promote competition as a means to ensure the efficient allocation of resources in an economy, resulting in the best possible choice of quality, the lowest prices and adequate supplies for consumers. In addition to promoting efficiency, many competition laws make reference to other objectives, such as the control of concentration of economic power, promoting the competitiveness of domestic industries, encouraging innovation, supporting small and medium-size enterprises and encouraging regional integration.

Most competition laws deal with enterprise *behaviour* by prohibiting such restrictive business practices as competition-restricting horizontal agreements, acquisitions and abuses of dominant positions, as well as substantially restrictive vertical distribution agreements. In addition, an increasing number of competition laws deals with alterations to the *structure* of markets, through the control of M&As, as well as joint ventures aimed at avoiding the creation of dominant firms, monopolies, or even oligopolies. In some laws, the divestment of 'parts of monopolies is also authorized, to change the structure of markets.[5]

According to the High Level Committee on Competition Policy and Law, appointed by Government of India, competition process is likely to run smoothly and thus lead to desirable results, only if several pre-requisites are met. Micro-industrial Governmental policies that may support or adversely impinge on the application of competition policy would include the industrial policy; reservation for the small scale industrial sector; privatization and regulatory reforms; trade policy, including tariffs, quotas, subsidies, anti-dumping action etc.; state monopolies policy; and labor policy.

The focus for most Competition Laws in the world today being in the three areas, viz. agreement among enterprises; abuse of dominance; mergers or, more generally, Combinations among enterprises, the Committee centred its recommendations on the same. Horizontal and Vertical agreements between firms have the potential of restricting competition. The Committee, therefore, recommended that both these types of agreements should be covered by the Competition Law.

The Committee felt that abuse of dominance rather than dominance should be the key for Competition Policy/Law. Abuse of dominance will include practices like restriction of quantities, markets and technical development. Abuse of dominance which prevents, restricts or distorts competition needs to be frowned upon by Competition Law. Relevant market needs to be an important factor in determining abuse of dominance.

The Committee which recommended that mergers need to be discouraged, if they reduce or harm competition., however, cautioned against monitoring of all mergers by the adjudicating Authority, for the reason that very few Indian companies are of international size and that in the light of continuing economic reforms, opening up of trade and foreign investment, a great deal of corporate restructuring is taking place in the country and that there is a need for mergers, amalgamations etc. as part of the growing economic process before India can be on an equal footing to compete with global giants, as long as the mergers are not prejudicial to consumer interest. It is in this context that

the Committee recommended that mergers beyond a threshold limit in terms of assets should require pre-notification.

Competition Policy/Law needs to have necessary provisions and teeth to examine and adjudicate upon anti-competition practices that may accompany or follow developments arising out of the implementation of *WTO* Agreements. In particular, agreements relating to foreign investment, intellectual property rights, subsidies, countervailing duties, anti-dumping measures, sanitary and phytosanitary measures, technical barriers to trade and Government procurement need to be reckoned in the Competition Policy/Law with a view to dealing with anti-competition practices.

Furthermore, the Committee recommended that the State Monopolies, Government procurement and foreign companies should be subject to the Competition Law. The Law should cover all consumers who purchase goods or services, regardless of the purpose for which the purchase is made.

As a follow cup of the Report of the Committee, the Union Cabinet on 26th June 2001 cleared a diluted bill on competition law and policies named Trade Related Competition Bill, to replace the Monopolies and Restrictive Trade Practices Act, 1969. It also proposes to set up a 10-member multidisciplinary Trade Related Competition Commission of India (TRCCI) to replace the existing Monopolies and Restrictive Trade Practices Commission (MRTPC).

ANNEXURE 20.1

MRTP ACT

The principal law in India to deal with competition was the Monopolies and Restrictive Trade Practices Act, 1969. The MRTP Act, brought into force from 1st June 1970, was a very controversial piece of legislation. The High Level Committee on Competition Policy and Law, appointed by Government of India, recommended that a new Competition Act may be enacted and the MRTP Act may be repealed. The Government has accepted this recommendation. The MRTP Act, one of the most controversial pieces of legislation in India, has thus become a document of historical value. The salient features of this Act is given her because of the importance with which it reined the industrial sector of the country.

The main objectives of the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, the principal law in India to deal with competition, were (1) Prevention of concentration of economic power to the common detriment, and (2) Control of monopolistic, restrictive and unfair trade practices which are prejudicial to public interest.

As a part of the economic reforms ushered in 1991, the MRTP Act was drastically amended by repealing the provisions of the Act pertaining to concentration of economic power, except the provisions empowering the Government to defuse concentration of economic power to the common detriment. In other words, the main thrust of the MRTP Act now is the achievement of prevention of monopolistic, restrictive and unfair trade practices. Thus, the 'M' has almost been knocked out of the MRTP Act. In other words, large companies have been freed from the MRTPA requirement of prior permission of the government for substantial expansion of existing undertakings, establishing new undertakings and M&As.

In accordance with the provisions of the Act, the Government of India had set up a Commission known as the Monopolies and Restrictive Trade Practices Commission. The MRTP Commission was vested with power to inquire into restrictive, monopolistic and unfair trade practices.

The MRTP Act empowered the Central Government to control and prohibit those monopolistic, restrictive and unfair trade practices that are, or are likely to be prejudicial to the public interest.

A monopolistic trade practice is a trade practice which has, or is likely to have, the effect of unreasonably preventing or lessening competition in the production, supply or distribution of any goods or services; limiting technical development and capital investment to the common detriment; or allowing the quality of goods or services to deteriorate.

A restrictive trade practice is a trade practice which has the effect, actual or probable of restricting, lessening or destroying competition. Such trade practices may tend to obstruct the flow of production or to bring about manipulation of prices or conditions of delivery etc. to the common detriment.

An unfair trade practice is a trade practice which, for the purpose of promoting the sale, use or supply of any goods or the provision of any services, adopts one or more unfair trade practices (like misleading advertisements) and thereby causes loss or injury to the consumers of such goods or services, whether by eliminating or restricting competition or otherwise.

The Act also empowered the Commission to make any undertaking or person to pay compensation to the party who suffered a loss or damage as a result of the unfair trade practice carried on by the undertaking or person.

The MRTP Act was severely criticized because of its growth defeating provisions. We had a very inept situation of not allowing Indian companies to grow by capacity expansion, establishment of new units or by M&A an because of the short supply importing goods produced by foreign multinationals which were far larger in size than the Indian biggies, spending the scarce foreign exchange.

As mentioned earlier, the High Level Committee on Competition Policy and Law has recommended that a new law called the Indian Competition Act may be enacted and the MRTP Act may be repealed.

The MRTP Act, besides adversely affecting economic growth, blunted Indian companies' ability to grow, consolidate and improve competitiveness. This has had a very dampening effect on their global competitiveness.

BOX 20.2 : POLICY PARADOX

It is indeed a paradox that laws like the MRTP Act which were designed to prevent monopoly have in effect restricted competition. The MRTP Act has helped to protect the market position of the large houses by restricting the competition between the large houses.

It is quite evident that the restrictions on the big houses have had many adverse effects — they have retarded competition, decelerated growth in the industrial and consequently in other sectors, and contributed to the foreign trade gap. *For example*, in the early seventies, having failed to make any headway within India, the only alternative left for the Birlas was to set up firms in other countries and it put up several successful companies in all the ASEAN countries. "This was surely a paradox. The same government which refused us permission to set up manufacturing capacities within the country, allowed us to set up industries outside the country for the same products for which it had said 'no' in [illegible] viscose staple fibre plant in Thailand, and started exporting fibre back to India." ([illegible] "State and industry must work together", *Business India*, 30th April 1988, p. [illegible])

REFERENCE

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2. S. Chakravarthy, "Role of Competition Policy in Economic Development and the Indian Experience", *Asian Economic Review*, December 1999, pp. 386-7.
3. *Ibid.*, p. 392.

4. UNCTAD, *World Investment Report 1997*, p. 190.
5. *Ibid.*, p. 190.
6. *Ibid.*, p. 190.
7. Cited by Chakravarthy, *op. cit.*, p. 393.
8. UNCTAD, *World Investment Report 1997*, p. 190
9. UNCTAD, *World Investment Report 2000*, p. xxvii.

Part 4

THE FINANCIAL SYSTEM

The characteristics of the financial system have important bearing on the business and economic development of the country. The State, through several promotional and regulatory measures, has been making a significant contribution towards the healthy development of the financial system.

The financial system of a nation consists of all those interdependent factors which promote, facilitate and regulate financial flows within the economy. These include:

- The financial intermediaries like banks, NBFIs and other financial service providers.
- Promotional and regulatory organisations like the central bank (RBI) and SEBI.
- Financial instruments like securities
- Facilitating markets like stock exchange, bill market and call money market.
- Laws and other regulations.

In other words, the financial system comprises of the financial markets and their functional mechanisms, including the promotional and regulatory factors. The financial market is made up, broadly, of two markets, *viz.*, the money market and the capital market.

BOX 21.1 : Rs. 5,376 CRORE BONANZA FOR CORPORATE SECTOR

The corporate sector was reported to be in for a Rs. 5,376 crore bonanza during the financial year 2001-02 due to the cuts in borrowing rates due to the reduction of the Bank Rate by one percentage point by the RBI and relief in direct and indirect tax proposed in the union budget for 2001-02.

A quick study by *Business Standard* Research Bureau, based on certain assumptions, covering 1025 companies has shown that they were likely to get a whopping Rs. 5,376 crore relief during financial year 2000 and 2001 on account of the above.

The major benefits for the corporates was estimated to come from the interest rate cuts. The 1025 companies were estimated to save Rs. 2,733 crore from the reduction in their borrowing costs.

On removal of ten per cent surcharge on distributable dividend, the data available with BSRB has shown that 690 companies which paid dividend of Rs. 11,307 crore during 1999-2000 were likely to save Rs. 1,131 crore, assuming that they would maintain the rate of dividend distribution during 2001-02. The proposed removal of ten per cent surcharge on corporate tax would be another benefit for the corporate sector. The 1025 companies would save Rs. 1,072 crore annually on account of the cut. The benefits on account of removal of surcharge on custom duty has been estimated at about Rs. 440 crore.

Courtesy: B.G. Shirsat, "Corporate sector in for Rs. 5,376 crore bonanza", *Business Standard*, March 2, 2001.

MONETARY POLICY

Monetary Policy refers to the use of instruments within the control of the Central Bank to influence the level of aggregate demand for goods and services or to influence the trends in certain sectors of the economy. Monetary policy operates through varying the cost and availability of credit, these producing desired changes in the assets pattern of credit institutions, principally commercial banks. These variations affect the demand for, and the supply of credit in the economy, and the level and nature of economic activities.

The modern economy is regarded as a credit economy in the sense that credit forms the basis of most of the economic activities in such an economy. The level and nature of economic activities such an economy, obviously, are influenced by the cost and availability of credit. The central bank's policies that affect the demand for and the supply of money, therefore, are very important to the industrial and commercial sectors. In a developed economy, credit forms a very important component of money supply.

Measures of Money Stock

A knowledge of the measures of money stock in an economy would help us to understand monetary policy better.

The Reserve Bank of India employs four measures of money stock, namely, M1, M2, M3 and M4.

M1: The measure of money stock designated by M1 is usually described as the money supply. The components of money supply are currency with the public (*i.e.*, notes in circulation, circulation of rupee coins and circulation of small coins) and deposits (demand deposits with banks and other deposits with the RBI). As on 23 March, 2001, M1 was Rs. 3,78,528 crore.

Currency with the public forms less than half of the total money supply, whereas the demand deposits constitute more than 50 per cent of the money supply today.

In advanced countries, demand deposis form a major part of the money supply. In India, the proportion of the currency in money supply has been declining. Two decades ago, it formed about three-fourths as against less than 50 per cent today.

M2: M2 is M1 + Post Office Savings Bank Deposits. As on 23 March, 2001, M2 was Rs. 3,83,569 crore.

M3: M3 is M1 + Time Deposits with the banks. In other words, M3 is money supply plus fixed deposits with the banks. M3 is usually referred to as aggregate monetary resources. As on 23 March, 2001, M3 was Rs. 13,06,091 crore.

M4: M4 is M3 plus the total Post Office Deposits. As on 23 March, 2001, M4 was Rs. 13,32,060 crore.

Monetary Policy and Money Supply

As has been mentioned earlier, money supply comprises currency with the public and demand deposits. Both the monetary and fiscal policies can affect money supply.

The budgetary operations of the Government considerably affect the money supply. If the Government meets its budgetary deficits by borrowing from the Reserve Bank, there will be an increase in money supply, both in currency and bank deposits. The RBI has no control over budgetary operations, though it has opportunities of tendering advice to Government on this matter.

Another source of variation in money supply, over which the RBI's influence is restricted, is the country's international payments position.

Demand deposits are a very important determinant of money supply. As has already been mentioned above, in advanced countries demand deposits form a major part of money supply. In many developing countries, the proportion of demand deposits in money supply has been increasing. This is a trend associated with economic development and improvements in the bankisation and banking habits of the people.

Deposits with banks may originate in two ways-through passive creation or active creation. The former occurs when banks open deposit accounts for customers against the receipt of value either in cash or cheques drawn on other banks. The latter takes place when banks create deposits by extending credits. In the first case, the immediate effect is that there is no addition to the quantum of money, though its distribution may undergo a change; but ultimately it enables the banks to extend credit and thus results in an increase in money. In the second instance, the supply of money is augmented immediately. When a bank extends credit, it would result partly in a rise in deposits either with itself or with other banking institutions. Under the fractional reserve system, the banks can create deposits by a multiple of the reserves, since the payments made with the proceeds of bank loans are eventually redeposited with banks, leading to additional reserve funds.

Central banking instruments of control operate by varying the cost and availability of credit, and these produce desired changes in the assets pattern of credit institutions, principally commercial banks. The item among banks' assets having special significance in this connection is the credit extended by banks to their constituents, which is the sum of what are usually called loans and discounts. The capacity of banks to provide credit depends on their cash reserves (comprising cash in hand and balances with the Reserve Bank), a substantial portion of the reserves being generally

Variable Reserve Ratios: Commercial banks in every country maintain, either by the requirement of law by or custom, a certain percentage of their deposits in the form of balances with the central bank. The central bank has the power to vary this reserve requirement; and the variation in the reserve requirements affect the credit creating capacity of commercial banks. For instance, if the reserve requirement is 10 per cent, the maximum amount the bank can lend is equivalent to 90 per cent of the total reserves. If the reserve ratio is raised to 20 per cent, the bank cannot lend more than 80 per cent of the total reserves.

The Reserve Bank of India is empowered to vary the cash reserve ratio between 3 per cent and 15 per cent of the total demand and time liabilities. To facilitate the flexible operation of this system, the RBI has also been vested with the power to require the scheduled banks to maintain with it additional cash reserves, computed with reference to the excess of their total demand and time liabilities over the level of such liabilities on the base date to be notified by the Reserve Bank, subject to the proviso that the total reserve to be maintained with the Bank should not exceed 15 per cent of their demand, and time liabilities.

In March 2001, the Reserve Bank of India cut the CRR by half a percentage to 7.5 per cent and this was estimated to release over Rs. 4000 crore to the economy. This indicates the impact that variations in the CRR can have on the money supply and the economy.

SLR: Action has also been taken to prevent banks from offsetting the impact of variable reserve requirements by liquidating their Government security holdings. The Banking Regulation Act has been amended, requiring all banks to maintain a minimum amount of liquid assets which shall not be less than a certain specified percentage of their demand and time liabilities in India, exclusive of the cash balances maintained under Section 42 of the Reserve Bank of India Act in the case of schedule banks, and exclusive of the cash balances maintained under Section 18 of the Banking Regulation Act in the case of non-scheduled banks. This ensures that with every increase in the cash reserve requirements, the overall liquidity obligations are also correspondingly raised.

Selective Credit Regulation: Selective and qualitative credit control refers to regulation of credit for specific purposes or branches of economic activity. While general credit controls operate on the cost and total volume of credit, selective controls relate to the distribution or direction of available credit supplies. It may be mentioned here that some element of selectivity can be imparted to general credit controls also by giving concessions to priority sectors or activities. This has often been done in India.

The aim of selective controls is to discourage such forms of activity as are considered to be relatively inessential or less desirable. Selective credit controls have been used in the Western countries to prevent the demand for durable consumer goods outrunning the supply, and generating inflationary pressure. In the USA, they have been used to regulate stock market credit as well. In India, such controls have been used to prevent speculative hoarding of commodities like foodgrains and essential raw materials to check an undue rise in their prices. In addition to selective credit controls, many central banks have acquired powers of direct regulation of the total magnitude, as also the distribution of advances and investments of individual banks as well as of the entire banking system.

Selective credit controls are considered to be a useful supplement to general credit regulation. From available experience, it appears that their effectiveness is greatly enhanced when they are used together with general credit controls. They are designed specifically to curb excesses in selected

area without affecting other types of credit. They attempt to achieve a reasonable stabilisation of the prices of particular commodities on the demand side, by regulating the availability of bank credit for purchasing and holding them. It should, however, be noted that prices are determined by the interaction of supply and demand, and that when supply is substantially short, what selective credit controls are likely to accomplish is to moderate the price rise rather than arrest the basic trend.

The Banking Regulation Act confers on the Reserve Bank the power to give directions to banking companies, either generally or to any banking company or group of banking companies in particular, as to—

(a) the purposes for which advances may or may not be made;

(b) the margin to be maintained in respect of secured advances;

(c) the maximum amount of advances or other financial accommodation which, having regard to the paid-up capital, reserves and deposits of a banking company and other relevant considerations, may be made by that banking company to any one company, firm, association of persons or individual;

(d) the maximum amount up to which, having regard to the considerations referred to in clause *(c)* guarantees may be given by a banking company on behalf of any one company, firm, association of persons or individual; and

(e) the rate of interest and other terms and conditions on which advances or other financial accommodation may be made or guarantees may be given.

The Reserve Bank is also empowered to issue, from time to time, to banking companies generally or to any banking company in particular, such directions as it deems fit in the public interest; or in the interest of banking policy; or to prevent the affairs of any banking company from being conducted in a manner detrimental to the interests of the depositors; or in a manner prejudicial to the interests of the banking company, or to secure the proper management of any banking company generally. The banking companies or the banking company, as the case may be, shall be bound to comply with such directions.

Further, the Reserve Bank may caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company.

From time to time, the Reserve Bank has asked banks in its circular letters to exercise caution in their lending in general as well as lending against the security of specified commodities and shares.

The techniques of selective credit controls used generally are:

(a) Minimum margins for lending against specific securities;

(b) Ceilings on the amounts of credit for certain purposes; and

(c) Discriminatory rates of interest charged on certain types of advances;

In India, selective credit controls are operated under all the three techniques. While imposing selective controls, care is generally taken to ensure that credit for production, the movement of commodities and exports, is not affected. Selective controls are focused mainly on credit to traders financing inventories.

Moral Suasion: In addition to the abovementioned methods of credit control, both quantitative and qualitative, it may be noted that the use has also been made in this country of moral suasion.

3. Effect improvements in income distribution;
4. Promote exports and encourage import substitution; and
5. Achieve economic stabilisation.

To serve these purposes, apart from the judicious allocation of the Budgetary resources, various fiscal incentives and disincentives are also employed by the Budget. An examination of the Budget Proposals will make these very clear.

Certain sectors or industries may be significantly impacted by the budget proposals like tax proposals or budgetary allocations. See box 21.2.

BOX 21.2 : BUDGET BLUES

Car and two wheeler companies announced an across the board cut in prices of their various models as a result of the eight per cent reduction in excise duty on passenger cars and two wheelers announced in the Union Budget for 2001-2002. Prices of Hyundai Motor's Santro have been slashed between Rs. 19,000 - 20,500. Rival Daewoo Motor's Matiz will become cheaper by around Rs. 16,500 to Rs. 23,000 across its four variants, nationwide.

The impact of the excise reduction is being felt on the mid-size segment also. General Motors has announced a reduction in the prices of its cars, Opel I Astra and Corsa, ranging from Rs. 30,000-Rs. 48,000 across all models including the Astra 2001 I and Corsa Royalle.

Honda Siel Cars India Ltd has slashed ex-showroom prices in Delhi of all its models in the range of Rs. 27,000 to Rs. 39,000.

Hindustan Motors' Contessa car will be priced Rs 30,000 lower Company sources also disclosed that the ex-showroom prices of the premium mid-size car Lancer, manufactured in collaboration with Mitsubishi Motors of Japan, have been reduced by Rs. 40,000 to Rs. 50,000. Even the old workhorse Ambassador will come cheap: it will cost almost Rs. 20,000 to Rs. 25,000 less.

In the two-wheeler segment, India's largest motorcycle maker Hero Honda Motors today effected a Rs. 1,740-Rs. 3000 price cut and predicted that it would exceed its Rs. 3,000 crore turnover target for this fiscal.

Courtesy : Business Standard, March 2, 2001.

In short, both monetary and fiscal operations have repercussions on the whole economy, affecting the price level, the balance of payments, the levels of industrial activity and employment. While the monetary policy influences economic trends, especially investment, through the cost and availability of credit, fiscal policy directly affects the financial resources and purchasing power in the hands of the public. In a country which has adopted a programme of planned economic development, in which the public sector has an important part to play, fiscal policy is concerned largely with effecting structural changes in the economy, while monetary policy aims at regulating investment in the private sector and short-run management of the economy. When economic objectives are set, both monetary and fiscal policies should aim at achieving these objectives. If they are to be successful, a close co-ordination of monetary and fiscal policies is necessary, for they are complementary and not competitive.

SUMMARY

The Monetary and Fiscal Policies are two important instruments employed by the authorities to influence the behaviour and performance of the financial sector and the economy in general. They may also be used to influence specific sectors or industries or segments. In other words, the fiscal and monetary policies are also important determinants of business prospects and investment decisions. They can help make the overall economic situation and business prospects bright or check an unwarranted boom or unhealthy demand explosion. They can encourage investment and production in certain priority sectors and discourage them in the non-priority sectors. They are also capable of influencing technological choice and investment and production patterns.

Monetary Policy refers to the use of instruments within the control of the monetary authority (*i.e.*, the Central Bank of the country – the Reserve Bank of India) to influence the level of aggregate demand for goods and services or to influence the trends in certain sectors of the economy. Monetary policy operates through varying the cost and availability of credit. These variations affect the demand for, and the supply of credit in the economy, and the level and nature of economic activities.

There are, broadly, two instruments of monetary policy (methods of credit control), *viz.*, General (Quantitative) methods; and Selective (Qualitative) methods.

The general methods affect the total quantity of credit and the economy generally. There are three general or quantitative instruments of credit control, namely, the Bank Rate, Open Market Operations and Variable Reserve Requirements.

The Bank Rate, also known as the Discount Rate, refers to the minimum rate at which the central bank provides financial accommodation to commercial banks in the discharge of its function as the lender of the last resort. The lending rate of the commercial banks increase or decrease in accordance with the Bank Rate. The variation in the lending rate affects the demand for credit and, thereby, the money supply. Open Market Operations refer broadly to the purchase and sale by the central bank of a variety of assets, such as foreign exchange, gold, Government securities and even company shares Under the Open Market operations, the central bank seeks to influence the economy either by increasing the money supply or by decreasing the money supply. To increase the money supply, the central bank buys securities from commercial banks and public. A sale of securities by the central bank will have the effect of reducing the money supply. Commercial banks in every country maintain, either by the requirement of law or by custom, a certain percentage of their deposits in the form of balances with the central bank. The central bank has the power to vary this reserve requirement; and the variation in the reserve requirements affects the credit creating capacity of commercial bank.

In considering the general methods of credit control, it is important to stress that these are closely inter-related and have to be operated in co-ordination. All the three instruments affect the level of bank reserves. Open Market Operations and the Reserve Requirements directly affect the reserve base, while the Bank Rate produces its impact indirectly by variations in the cost of acquiring the reserve. The use of one instrument rather than another at any point of time is determined by the nature of the situation and the range of influence it is desired to wield as well as the rapidity with which the change is required to be brought about.

The selective methods are intended to affect certain select sectors. In other words, under the selective methods, certain qualitative distinctions are made between different sectors and segments of the economy; and selectivity is applied in regulating the flow of credit. While general credit controls operate on the cost and total volume of credit, selective controls relate to the distribution or direction of available credit

fund requirements. In terms of sources of credit, they could be broadly categorised as institutional and non-institutional.

The major institutional surveyors of credit in India are banks and non-banking financial institutions, *i.e.*, development financial institutions (DFIs) and other financial institutions (FIs) and non-banking financial companies (NBFCs) including housing finance companies (HFCs).

The non-institutional or unorganised sources of credit include money-lenders, indigenous bankers and sellers for trade credit.

An important aspect of the credit market is its term structure, *viz*., *(i)* short-term credit, *(ii)* medium-term credit, and *(iii)* long-term credit. While banks and NBFCs predominantly cater to short-term needs, FIs provide mostly medium and long-term funds.

Banks: Banks in India can be broadly classified as commercial banks and co-operative banks. In terms of ownership and function, commercial banks can be grouped into three categories — public sector banks, regional rural banks and private sector banks (both domestic and foreign). These banks have over 67,000 branches spread wide across the country. After initiation of financial sector reforms, competition in the banking sector has increased. As result of the removal of restrictions on project financing, the share of term loans as percentage of total bank loans went up considerably — to 34.9 per cent as at the end of March 1999 from 26.1 per cent as at end-March 1995.

An important development in the financial sector in the recent years has been the diversification and growth of *para-banking* activities such as, leasing, hire purchase, factoring, *etc.* The reasons for banks entering para-banking activities include the need for diversifying earnings, maximising economies of scale and scope, making profits, and also the desire to have leading market positions in financial services. Following the erstwhile UK model, in India these diversified financial activities are undertaken mostly by subsidiaries of banks.

Merchant banking is an important area where subsidiaries of banks have made their presence felt. Merchant banking includes services such as pre-issue, management of public issue, *etc.*, and as such is dependent on the conditions in the stock market.

The dealing in government securities is another area where banks have been fairly active. Venture capital is a new area where banks have entered. Many banking subsidiaries, are also quite active in the field of housing finance. Banking subsidiaries are also operating in the credit card business.

There is a shared responsibility between the Reserve Bank and SEBI in the regulation of para banking activities of banks. In India, a prudential regulatory framework based on capital adequacy is in place in the case of para-banking subsidiaries as well.

Financial Institutions: A large variety of financial institutions has come into existence over the years to perform a variety of financial activities. While some of them operate at all-India level, others are state level institutions. All-India financial institutions (AIFIs) consist of all-India development banks, specialised financial institutions, investment institutions and refinance institutions. The state level institutions, on the other hand, comprise 18 State Financial Corporations (SFCs) and 26 State Industrial Development Corporations (SIDCs).

All-India development banks (IDBI, IFCI, ICICI, SIDBI and IIBI) occupy an important position in the financial system as the main source of medium and long-term project finance to industry. Besides, specialised financial institutions are also operating in the areas of export-import (EXIM

Bank, infrastructure (IDFC), tourism (TFCI) and venture capital (IVCF, ICICI Venture). Investment institutions in the business of mutual fund (UTI) and insurance activity (LIC, GIC and its subsidiaries) have also played significant roles in the mobilisation of household sector savings and their deployment in the credit and the capital markets. In the agriculture and rural sector and the housing sector, the NABARD and NHB respectively, are acting as the chief refinancing institutions. Both of them are also vested with certain supervisory functions.

Besides providing direct loans (including rupee loans, foreign currency loans), financial institutions also extend financial assistance by way of underwriting and direct subscription and by issuing guarantees. Recently, some development financial institutions (DFIs) have started extending short term/working capital finance, although term-lending continues to be their primary activity.

Non-Banking Financial Companies (NBFCs): Non-banking financial companies (NBFCs) are financial intermediaries engaged primarily in the business of accepting deposits and making loans and advances, investments, leasing, hire purchase, *etc.* NBFCs are a heterogeneous lot. NBFC sector is characterised by a large number of privately owned, decentralised and relatively small-sized financial intermediaries. NBFCs are of various types, such as, loan companies (LCs), investment companies (ICs), hire purchase finance companies (HPFCs), equipment leasing companies (ELCs), mutual benefit financial companies (MBFCs) also known as Nidhis, miscellaneous non-banking companies (MNBCs) also known as Chit Funds and residuary non-banking companies (RNBCs). Loan companies, investment companies, hire purchase finance companies and equipment leasing companies are defined on the basis of the principal activity of their business. Although NBFCs in India have existed for a long time, they shot into prominence in the second half of the 'eighties and in the first-half of the 'nineties, as deposits raised by them grew rapidly. Customer orientation, concentration in the main financial centres and attractive rates of return offered by them are some of the reasons for their rapid growth. Primarily engaged in the area of retail banking, they face competition from banks and financial institutions.

Housing Finance Companies (HFCs): In India, investment in housing is mainly financed by own sources or from informal credit market. The formal housing finance institutions contribute only a small percentage of housing investments in the country. However, within the formal housing finance sector, the conventional sources of housing finance in India have been the public sector institutions. Over the years, they were found to be grossly inadequate to meet the requirements of the new investments and maintenance of housing and habitat systems. Accordingly, since the mid-eighties, efforts have been directed at the development of housing finance institutions to meet the large resource gap that exists for housing finance in the country. A policy shift to encourage private and cooperative sectors in housing could be discerned and the necessary legal and regulatory changes are being effected in this regard.

The formal segment of housing finance includes funding provided by the Central and State Governments and funds from financial institutions like GIC, LIC, commercial banks and specialised housing finance institutions and cooperative banks. HUDCO was set up in April 1970 as an apex techno-finance organisation in order to provide loans and technical support to state and city level organisations. The State Governments are responsible for implementing social housing schemes. Almost all the States have set up Housing Boards in order to facilitate the implementation of the social housing schemes. Co-operative banks have been financing housing schemes. Co-operative banks cater to economically weaker sections, low and middle income groups as well as co-operative or group housing societies. The second formal tier of the housing finance consists of insurance corporations, commercial banks and housing finance companies.

The Government securities market witnessed significant transformation in the 1990s. Its development was constrained mainly by lack of definite limits on the automatic monetisation of the Central Government budget deficits and by relatively low coupon rates offered on the Government securities. The artificially low yield on Government securities had an impact on the entire yield structure of financial assets in the system. Both these factors were corrected during the 'nineties. As regards the secondary market, there was not much activity which was hindered by low bond yields and predominance of captive investors. The secondary market activity increased following the introduction of auction based yields. The activity in the secondary market could further pick up once bond yields are better aligned and investors, other than institutions (banks and insurance companies) start actively transacting in the market.

As a part of developing money market instruments, a variety of Treasury bills, *viz.*, 14-day, 91-day, 182-day, 364-day maturities have been introduced. Innovations have also been introduced with respect to long-term bonds, which include zero coupon bonds, floating rate bonds and capital indexed bonds.

The main investors in the Government securities market in India are commercial banks, co-operative banks, insurance companies, provident funds, financial institutions (including term-lending institutions), mutual funds especially the gilt funds, primary dealers, satellite dealers, non-bank finance companies and corporate entities. The Reserve Bank also absorbs primary issuance of Government securities, either through private placement or devolvement. Though banks have traditionally been the dominant investors in the Government securities due mainly to SLR requirements, they have, in recent years, found it advantageous to invest in the Government securities beyond the statutory requirements partly because of the better risk-return characteristic of such securities in the context of adherence to capital adequacy requirements and partly because of relatively sluggish demand for commercial credit.

A large participant base reduces the borrowing cost for the Government, reduces market volatility and imparts competition in the market. A market with adequate depth and liquidity for participants with different perceptions and liquidity requirements should emerge; this is also essential to avoid unidirectional movements in the market. The present structure of the Government securities market is predominantly institutional, while the household participation is negligible or nearly absent. Foreign Institutional Investors (FIIs) are also permitted to invest in the dated Government securities and Treasury bills, both in the primary and secondary markets, within the overall debt ceilings.

A crucial issue in the development of the Government securities market is the need for a well functioning secondary market, which requires *(i)* a transparent system of trading; *(ii)* a secure system of settlement of transactions; *(iii)* an institutional structure whereby the market players have divergent perceptions about liquidity and interest rates; and *(iv)* a liquid market with a matured system of price determination. To develop the secondary market for the Government securities, the following measures were initiated.

Secondary Market Window: The central banks often play the role of market makers providing two-way quotes through their sales window to infuse liquidity in the secondary market for the Government securities. Generally, two approaches are adopted for operating the secondary market window by the central banks: *(i)* fixing buying and selling prices and announcing them to the market, and *(ii)* using a dynamic approach whereby the secondary market window pricing is continuously adjusted in response to the market dynamics. During the initial stages of market development, the

Reserve Bank used to announce the sale and purchase prices of securities. In the recent period, however, the Reserve Bank has offered a select list of securities for sale, depending upon supply and demand conditions. A few securities are also included in the purchase list, with a view to improving liquidity through select securities. The sale/purchase prices and the securities offered on sale are frequently revised.

Discount House Arrangements: The DFHI was originally set up in April 1988 for developing the money market. It was also allowed to participate in Treasury bills and dated securities. Further, for developing an efficient institutional infrastructure for an active secondary market in Government securities and public sector bonds, the Securities Trading Corporation of India (STCI) was set up in May 1994. Both DFHI and STCI later transformed themselves into PDs.

Primary Dealer System: The primary dealer system was evolved and made functional in 1996 with the objective of strengthening the securities market infrastructure and bringing about improvement in the secondary market trading, liquidity and turnover in Government securities as also encouraging their voluntary holding amongst a wider investor base. PDs have ensured maximum participation in the auctions of Government securities. In the secondary market, they act as market makers by providing continuous two-way quotes thereby ensuring liquidity and support to the success of primary market operations. The system also creates appropriate conditions for open market operations of the Reserve Bank and facilitates the transfer of market making activities from the Reserve Bank to the market agents.

Satellite Dealers: With a view to broadening the market with a second tier of dealer system in trading and distribution and imparting greater momentum in terms of increased liquidity and turnover, a system of SDs was put in place in December 1996. The network of satellite dealers provides retail outlets thereby encouraging voluntary holding of Government securities among a wide investor base. The SDs are also given limited liquidity support from the Reserve Bank.

Gilt Funds: The Reserve Bank also encouraged setting up of mutual funds dealing exclusively in gilts, called gilt funds with a view to encouraging schemes of mutual funds dedicated to Government securities and creating a wider investor base for them. Mutual funds dedicated exclusively to investment in Government securities are also provided liquidity support by the Reserve Bank by way of reverse repos in Central Government securities outstanding at the end of the previous calendar month.

The market efficiency is significantly influenced by the transaction costs or costs of trading. The transaction costs are, in turn, determined by the type of trading, clearing and settlement system existing in a market. A well developed market in Government securities requires a system of transparent pricing and allotment, which, in a special sense, refers to information needs. In turn, such a system would imply active market making activity and broad-based participation. The National Stock Exchange (NSE) introduced a transparent screen-based trading system in the wholesale debt market, including Government securities in June 1994. The trading system known as National Exchange for Automated Trading (NEAT) is a fully automated screen-based trading system. The Over the Counter Exchange of India (OTCEI) also started trading in Government securities in July 1997. However, a major part of government securities transaction in the secondary market is operated through over-the-counter negotiated deals. The brokers, who are members of the NSE and OTCEI can transact business on behalf of commercial banks. The OTCEI and NSE markets complement each other. As announced in the Mid-term Review of Monetary and Credit Policy for 2000-01, the

sector reforms in the early 'nineties was essentially to bring about a transformation in the structure, efficiency and stability of financial markets, as also an integration of the markets. Some of the important structural changes enabled by financial sector reforms relate to introduction of free pricing of financial assets in almost all segments, relaxation of quantitative restrictions, removal of barriers to entry, new methods of floatation/issuance of securities, increase in the number of instruments and enlarged participation, improvement in trading, clearing and settlement practices, improvement in the informational flows, transparency and disclosure practices.

The credit market is the predominant source of finance in India as the capital market is relatively underdeveloped, firms or economic entities depend largely on the credit market for their fund requirements. In terms of sources of credit, the financial intermediaries providing credit could be broadly categorised as institutional and non-institutional.

The major institutional purveyors of credit in India are banks and non-banking financial institutions, *i.e.*, development financial institutions (DFIs) and other financial institutions (FIs) and non-banking financial companies (NBFCs) including housing finance companies (HFCs). The non-institutional or unorganised sources of credit include money-lenders, indigenous bankers and sellers for trade credit.

The foreign exchange market in India comprises customers, authorised dealers (ADs) and the Reserve Bank. With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual but significant liberalisation of restrictions on various external transactions, the forex market in India has acquired more depth.

There has been a considerable improvement in the forex market turnover in the recent years, particularly during the post-reform period. The inter-bank turnover constitutes the predominant part of total turnover. As regards the classification by way of spot and forward transactions, available data for the recent period indicate that the merchant segment is dominated by spot transactions, while the inter-bank segment is dominated by forward transactions.

The Reserve Bank's presence in the market essentially reflects its policy of ensuring orderly market conditions. Reflecting its stance, net intervention sales of the Reserve Bank generally coincided with conditions of excess demand in the market, while net intervention purchases coincided with surplus market conditions and contributed to reserve build-up.

The domestic debt market comprises two main segments, *viz.*, the Government securities and other (mainly corporate) securities comprising private corporate debt, PSU bonds and DFIs bonds. The government securities market is pre-dominant, while the other segment is not very deep and liquid.The corporate debt market still constitutes a small segment of the debt market despite policy initiatives taken during the 'nineties. DFI bonds have emerged as an important segment of the debt market. Since the middle of the 'eighties, long-term bond issues (maturity 5-10 years) by public sector undertakings (PSUs) imparted a new dimension to the debt market. While traditionally most of the PSU bonds were floated in the public issues market, in the recent years, most of such bond issues were privately placed. This is one reason why secondary market activity in PSU bonds has been limited.

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1. The material of this chapter is drawn mostly from the Reserve Bank of India, *Report on Currency and Finance, 1999-2000*, Reserve Bank of India, Mumbai, 2001.

CHAPTER 23 PART 4

MONEY AND CAPITAL MARKETS

Money and Capital Markets are two most important components of the Financial Market.

MONEY MARKET

Meaning of Money Market

Money Market is the market for short-term funds, as distinct from the Capital Market which deals in long-term funds.

Sometimes the term Money Market is used in a very broad sense to include markets for both the short-term, and long-term funds. When the term is used in such a broad sense, Money Market includes, obviously, the Capital Market also. However, when a distinction is drawn between the Money Market and the Capital Market, the former refers only to the market for short-term funds, and the latter for long-term funds. As we draw, in this chapter, a distinction between these two, Money Market should be interpreted as the market for short-term funds.

In the words of the Reserve Bank of India, a Money Market is a "centre for dealings, mainly of a short-term character, in monetary assets; it meets the short-term requirements of the borrowers and provides liquidity or cash to lenders. It is the place where short-term surplus investible funds at the disposal of the financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."[1]

Thus, a Money Market is a place where the lending and borrowing of short-term funds are arranged and it comprises the short-term credit instruments and the institutions and individuals who participate in the lending and borrowing business.

Constituents of Money Market

Dr. Lavington divides the money market into inner and outer spheres—the inner constituting "a nucleus of specialised institutions such as the banks, the market for negotiable securities, the bill brokers and the trust and finance companies, and the outer extending beyond this centre, including the work of solicitors, of brokers of securities and the entire system of trade and credit."

The central bank, commercial banks, co-operative banks, savings banks discount houses, acceptance house, etc., are the main constituents of a well developed money market. However, some of these institutions would not be found in some money markets.

ushered in 1991, the Indian market has been getting linked, albeit in a limited way, to the global market.

The money market structure has undergone a change over the years, particularly under the impetus of the economic reforms. Unlike in developed economies where money markets are promoted by financial intermediaries out of efficiency considerations, in India, as in many other developing countries, the evolution of the money market and its structure has been integrated into the overall deregulation process of the financial sector.

The Reserve Bank has gradually developed money markets through a five-pronged effort. First, interest rate ceilings on inter-bank call/notice money, inter-bank term money, rediscounting of commercial bills and inter-bank participation without risk were withdrawn effective May 1, 1989. Secondly, several financial innovations in terms of money market instruments, such as, auctions of Treasury Bills, certificates of deposit, commercial paper and RBI repos were introduced. Thirdly, barriers to entry were gradually eased by *(i)* increasing the number of players (beginning with the Discount and Finance House of India (DFHI) in April 1988 followed by primary and satellite dealers and money market mutual funds), *(ii)* relaxing both issuance restrictions and subscription norms in respect of money market instruments and allowing determination of yields based on demand and supply of such paper, and *(iii)* enabling market evaluation of associated risks, by withdrawing regulatory restrictions, such as, bank guarantees in respect of CPs. Fourthly, the development of markets for short-term funds at market determined interest rates has been fostered by a gradual switch from a cash credit system to a loan-based system, shifting the onus of cash management from banks to borrowers and phasing out the 4.6 per cent 91-day tap Treasury Bills, which in the past provided an avenue for investing short-term funds. Finally, institutional development has been carried out to facilitate inter-linkages between the money market and the foreign exchange market, especially after a market-based exchange rate system was put in place in March 1993.

The changes in the money market structure need to be seen in the context of a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities. The development of money markets in India in the last half of the 1990s has been facilitated by three major factors. First, the limiting of almost automatic funding of the government, largely realised with the replacement of *ad hoc* Treasury Bills (which bore a fixed coupon rate of 4.6 per cent per annum from July 1974, implying a negative real interest rate for most part of the period) by ways and means advances (WMA) at interest rates linked to the Bank Rate and the development of the government securities market, discussed later in the chapter, permitting a gradual de-emphasis on cash reserve ratio as a monetary policy instrument. Secondly, the development of an array of instruments of indirect monetary control, such as, the Bank Rate (re-activated in April 1997), the strategy of combining auctions, private placements and open market operations in government paper and the liquidity adjustment facility (LAF). Thirdly, the enabling institutional framework was introduced in the form of primary and satellite dealers and money market mutual funds. The monetary authority uses money markets to adjust primary liquidity in the domestic economy and monetary policy is often, in turn, shaped by developments in the money and the foreign exchange markets.

Money Market Instruments and Constituents[2]

The money market instruments in India mainly comprise: *(i)* call money, *(ii)* certificates of deposit, *(iii)* treasury bills, *(iv)* other short-term government securities transactions, such as, repos, *(v)* bankers' acceptances/commercial bills, *(vi)* commercial paper, and *(vii)* inter-corporate funds.

While inter-bank money markets and central bank lending *via* repo operations or discounting provide liquidity for banks, private non-bank money market instruments, such as, commercial bills and commercial paper provide liquidity to the commercial sector.

Call/Notice Money Market: Call and notice money are money dealt for one to 14 days. The period of term money ranges from 14 days to 90 days. This is sometimes a very volatile market and the interest rate is determined by the market forces. This market is of vital importance to banks and financial institutions because of the avenue it provides for investing surplus funds and meeting the deficits. The Inter-bank lending is the major component of this market.

The overnight inter-bank call money market, in which banks trade positions to maintain cash reserves, is the key segment of the money market in India. It is basically an 'over the counter' (OTC) market without the intermediation of brokers. Participation has been gradually widened to include other financial institutions, primary/satellite dealers, mutual funds and other participants in the bills rediscounting market and corporates (through primary dealers) besides banks, LIC and UTI. While banks and primary dealers are allowed two-way operations, other non-bank entities can only participate as lenders. As per the announced policies, once the repo market develops, the call money market would be made into a pure inter-bank market, including primary dealers.

The call money market is influenced by liquidity conditions (mainly governed by deposit mobilisation, capital flows and the Reserve Bank's operations affecting banks' reserve requirements on the supply side and tax outflows, government borrowing programme, non-food credit off-take and seasonal fluctuations, such as, large currency drawals during the festival season on the demand side). At times of easy liquidity, call rates tend to hover around the Reserve Bank's repo rate, which provides a ready avenue for parking short-term surplus funds. During periods of tight liquidity, call rates tend to move up towards the Bank Rate and more recently the Reserve Bank's reverse repo rate (and sometimes beyond) as the Reserve Bank modulates liquidity in pursuit of monetary stability. Besides, there are other influences, such as, (i) the reserve requirement prescriptions (and stipulations regarding average reserve maintenance), (ii) the investment policy of non-bank participants in the call market which are among the large suppliers of funds in the call market, and (iii) the asymmetries of the call money market, with few lenders and chronic borrowers.

Term Money Market: The term money market in India is still not developed. Select financial institutions (IDBI, ICICI, IFCI, IIBI, SIDBI, EXIM Bank, NABARD, IDFC and NHB) are permitted to borrow from the term money market for 3-6 months maturity, within stipulated limits for each institution.

Repos: Repo is a money market instrument, which enables collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. Under a repo transaction, a holder of securities sells them to an investor with an agreement to repurchase at a pre-determined date and rate. In the case of a repo, the forward clean price of the bonds is set in advance at a level which is different from the spot clean price by adjusting the difference between repo interest and coupon earned on the security. Repo is also called a ready forward transaction as it is a means of funding by selling a security held on a spot (ready) basis and repurchasing the same on a forward basis. Reverse repo is a mirror image of repo as in the case of former, securities are acquired with a simultaneous commitment to resell.

Subsequent to the irregularities in securities transactions, repos were initially allowed in the Central Government Treasury Bills and dated securities created by converting some of the

long-term, as also commercial, industrial and government paper". When 'Capital Market' is used in such a broad sense, it embraces, obviously, the money market also.

However, in most cases, the term Capital Market is used to refer to the market for long-term loanable funds as distinct from the money market which deals in short-term funds. It should, however, be added that there is no clear-cut distinction between the two markets. Many a time the same institutions receive and supply both short and long-term funds. The money and capital market are in fact inter-dependent, developments and trends in one affecting the other.

Nature and Constituents

The capital market consists of a number of individuals and institutions (including the government) that canalise the supply and demand for long-term capital and claims on capital. The stock exchanges, commercial banks, co-operative banks, savings banks, development banks, insurance companies, investment trust or companies, etc., are important constituents of the capital market.

The capital market, like the money market, has three important components, namely, the suppliers of loanable funds, the borrowers and the intermediaries who deal with the lenders on the one hand and the borrowers on the other.

In the capital market, the supply of funds comes from the individual and corporate savings, institutional investors and surplus of governments. The demand for capital comes mostly from agriculture, industry, trade and the government.

With the emergence of joint stock companies as the predominant form of industrial organisation, developed capital market became a necessary infrastructure for fast industrialisation. Business firms can raise funds from the capital market by issuing shares and credit instruments. Capital market is not concerned solely with the issue of new claims on capital, but also with dealing in existing claims. In fact, marketability, of securities is an important element in the efficient working of the capital market, since investors would be reluctant to make loans if their claims could not be easily disposed of.

The developed countries have comparatively well-developed money and capital markets. But, in the developing countries the capital market, like the money market, is generally underdeveloped.

Importance of Capital Market

The pace of economic development is conditioned, among other things, by the rate of long-term investment and capital formation. And capital formation is conditioned by the mobilisation, augmentation and channelisation of investible funds. The capital market serves a very useful purpose by pooling the capital resources of the country and making them available to the enterprising investors. Well-developed capital markets augment resources by attracting and lending funds on a global scale. The Euro-currency and Eurobond markets are international finance markets in terms of both the supply and demand for funds.

The increase in the size of the industrial units and business corporations due to technological developments, economies of scale and other factors has created a situation where in the capital at the disposal of one or few individuals is quite insufficient to meet the investment demands. A developed capital market can solve this problem of paucity of funds. For an organised capital market can mobilise and pool together even the small and scattered savings and augment the availability of investible funds. While the rapid growth of capital markets, the growth of joint stock business has in its turn encouraged the development of capital markets.

A developed capital market provides a number of profitable investment opportunities for the small savers.

THE INDIAN CAPITAL MARKET

BOX 23.1 : INDIAN CAPITAL MARKET IN TRANSITION

Although the Indian capital market witnessed some significant changes during the 'eighties, both the primary and the secondary segments continued to suffer from some serious deficiencies. Many unhealthy practices prevailed in the primary market to attract the retail investors. Another disturbing feature was the high cost of new issues. Although over the years, a number of agencies came into existence offering different types of services in connection with the new issues of capital, their activities were not overseen by any regulatory authority. The problems were even more serious in the secondary market. The general functioning of stock exchanges was not satisfactory. The exchanges were governed by their internal bye-laws and managed by their Governing Bodies, which were dominated by elected member-brokers. Trading members were also not adequately capitalised. Insider trading was rampant and was one of the major causes of excessive speculative activity, leading to default by stock brokers, frequent payment crises and disruption of market activity. The stock exchanges followed inefficient and outdated trading systems. This, in turn, led to lack of transparency in trading operations, besides resulting in long and uncertain settlement cycles.

The risk management system in the market was also not satisfactory. Though the margin system was operative, the margins were inadequate and the system of collection of margins was not enforced strictly. Post-trade settlement procedures also suffered from some serious drawbacks, such as, high share of bad deliveries, delayed settlements, sometimes clubbing of settlements, etc. The procedures relating to investor protection were also not satisfactory.

Some measures were initiated to reform the capital market in the 'eighties. However, major reforms, which have altered the face of the capital market, were initiated beginning with the year 1992. In the primary market, all controls relating to pricing of equity issues and the time when they should be issued have been removed, while in the secondary market, the traditional open outcry system has been replaced with transparent screen-based computerised trading system. Physical securities are being increasingly dematerialised. The settlement period has been shortened to one week uniformly across all stock exchanges. The domestic capital market is also increasingly integrating with the international capital markets.

Courtesy : Reserve Bank of India, *Report on Currency and Finance*, 1999-2000.

Nature of the Indian Capital Market

Like the money market, the Indian capital market also consists of an organised sector and an unorganised sector. In the organised market the demand for capital comes mostly from corporate enterprises and government and semi-government institutions and the supply comes from household savings, institutional investors like banks investment trusts, insurance companies, finance corporations, government and international financing agencies.

The unorganised market consists mostly of the indigenous bankers and moneylenders on the supply side. While in the organised sector the demand for funds is mostly for productive investment, a large part of the demand for funds in the unorganised market is for consumption purposes. In fact, many purposes, for which funds are very difficult to get from the organised market, are financed by the unorganised sector. Like the unorganised money market, the unorganised capital market in India is characterised by the existence of multiplicity of interest rates, exorbitant rates of interest and lack of uniformity in their business dealings.

SUMMARY

Money and Capital Markets are two most important components of the Financial Market.

The term Money Market refers to the market for short-term funds, as distinct from the Capital Market which deals in long-term funds. However, sometimes these terms are used very broadly to include markets for both short and long term funds.

The money market and the capital market have three important components, namely, the suppliers of loanable funds, the borrowers and the intermediaries who deal with the lenders on the one hand and the borrowers on the other. In developing countries like India, the money and capital markets are broadly divided into organised and unorganised markets or sectors. The unorganised segment is, by and large, outside the control of the central bank and is characterised by lack of uniformity and formality in their business dealings. In India, the indigenous bankers and moneylenders are important constituents of the unorganised market. The co-operative credit institutions occupy a somewhat intermediate position between the organised and unorganised sectors of the money market.

The central bank, commercial banks, co-operative banks, savings banks discount houses, acceptance house, etc., are the main constituents of the money market. However, some of these institutions would not be found in some money markets. The central bank usually occupies a pivotal position in the money market. It is regarded as the 'presiding deity' of the money market. A strong central bank in an organised money market can very significantly influence the conditions and activities of the market.

A well-developed money market helps efficient operation of the monetary policy, channelisation of the savings of the society, reduction of seasonal and regional imbalances in the supply of and demand for funds, and reduction of gap between borrowing and lending rates. A money market functions like a dam-canal-irrigation system. Like a reservoir it collects and augments the resources and channelises it to the various needed areas.

The money market instruments in India mainly comprise: *(i)* call money, *(ii)* certificates of deposit, *(iii)* treasury bills, *(iv)* other short-term government securities transactions, such as, repos, *(v)* bankers' acceptances/commercial bills, *(vi)* commercial paper, and *(vii)* inter-corporate funds.

The capital market serves a very useful purpose by pooling the capital resources and making them available to the enterprising investors. Well-developed capital market augment resources by attracting and lending funds on a global scale.

The capital market consists of a number of individuals and institutions (including the government) that channelise the supply and demand for long-term capital and claims on capital. The stock exchanges, commercial banks, co-operative banks, savings banks, development banks, insurance companies, investment trust or companies, etc., are important constituents of the capital market.

The developed countries have comparatively well-developed money and capital markets. But, in the developing countries the capital market, like the money market, is generally underdeveloped.

The Indian capital market has undergone remarkable changes in the post-independence era. Certain steps taken by the government to place the market on a strong footing and develop it to meet the growing capital requirements of fast industrialisation and development of the economy have significantly contributed to the developments that took place in the Indian capital market over the last five decades or so.

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CHAPTER 24 PART 4

STOCK EXCHANGE AND ITS REGULATION

Meaning, Importance and Functions

Stock Exchange is a market in which securities are brought and sold and it is an essential component of a developed capital market.

According to the Securities Contracts (Regulation) Act, 1956, *stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.*

According to this Act, *securities* include *(i)* shares, scrips, stocks, bonds, debentures, stock or other marketable securities of a like nature in or of any incorporated company or body corporate; *(ii)* Government securities; such other instruments as may be declared by the Central Government to be securities; and *(iii)* right or interest in securities.

Stock exchange is regarded as "an essential concomitant of the capitalistic system of economy. It is indispensable for the proper functioning of corporate enterprise. It brings together large amounts of capital necessary for the economic progress of a country. It is the citadel of capital and the pivot of money market.

It provides necessary mobility to capital and directs the flow of capital into profitable and successful enterprises. It is the barometer of general economic progress in a country and exerts a powerful and significant influence as a depressant or stimulant of business activity. It may be defined as the place or market where securities of joint stock companies and of government or semi-government bodies are dealt in."[1]

Speaking in the *Lok Sabha* in connection with his motion for reference of the Securities Contracts (Regulation) Bill to a Joint Committee of the Houses of Parliament in 1955, the Finance Minister made the following observations.

The economic services, which a well constituted and efficiently run securities market can render to a country with a large private sector, operating under the normal incentives and impulses of private enterprises are considerable.

In the first place, it is only an organised securities market which can provide sufficient marketability and price continuity for shares, so necessary for the needs of investors.

Secondly, it is only such a market that can provide a reasonable measure of safety and fair dealing in the buying and selling of securities.

Thirdly, through the interplay of demand for and supply of securities, properly organised stock exchange assists in a reasonably correct evaluation of securities in terms of their real worth. Lastly,

Organisation of Stock Exchange in India

There are 23 stock exchanges functioning in India including the Over The Counter Exchange of India (OTCEI) and the National Stock Exchange (NSE).

The Bombay Stock Exchange, which was established in 1875 as "The Native Share and Stockbrokers Association" (a voluntary non-profit making association) is the oldest one in Asia; the Tokyo Stock Exchange was founded only in 1878.

With about 10,000 listed companies, India holds the unique distinction of having the largest number of listed companies in the world. The number of investors is one of the largest in the world.[4]

Since the coming into effect of the Securities Contracts Act, 1956, only those stock exchanges which are recognised by the Government can function in the country. The policy of the Government is that there shall be only one stock exchange in one area. In pursuance of this policy, where more than one stock exchange existed as in Bombay only one stock exchange was given recognition and the active members of the non-recognised stock exchanges were admitted.

Some stock exchanges like Bombay, Indore and Ahmedabad are organized as Voluntary Association; some like Calcutta and Delhi are organised as public limited companies whereas some like Hyderabad, Madras and Bangalore are guarantee companies.

Each stock exchange is managed by an Executive Committee/Council of Management/ Governing Body to which the Government is empowered to nominate not more than three members. The rules and bye-laws of the stock exchange shall be in conformity with such conditions as may be prescribed by the Government. The Securities Contracts (Regulation) Act empowers the Government also to withdraw the recognition granted to a stock exchange, in the interest of trade or in public interest. Further, in order to deal with abnormal and extraordinary situations which may develop from time to time. Government is empowered to supercede a governing body after giving an opportunity to the governing body to be heard in the matter and to appoint in its place any person or persons to perform the functions of the governing body; and to suspend such of the business of a stock exchange under certain circumstances, for such period not exceeding seven days as may be specified, in the interest of trade or in public interest. The period of suspension can be extended from time to time, but after the governing body has been given an opportunity of being heard in the matter.

Dealers and brokers dealing outside the area of the recognised stock exchange have to obtain licence from the Government.

Only members and their authorised clerks can enter the trading floor and conduct buying and selling of securities. There are brokers and other intermediaries who assist the buyers and sellers in their dealings.

Members: In the past, only an individual (not a firm or company) could be a member. Now companies can also become members. Multiple membership, *i.e.*, membership in more than one stock exchange is also permitted.

Authorised Clerks: To assist the members for making transactions on the exchange, members are permitted to appoint a fixed number of authorised clerks. The number of authorised clerks varies from one exchange to another. The authorised clerks, as agents of the members, can enter the trading floor and buy or sell on behalf of their employers; but they cannot buy or sell on their own account.

Remisers: The remisers are sub-brokers employed by a member to secure business. The remisers are not permitted to enter the trading floor for exchange dealing. They are meant primarily to secure business from the outsiders. The remisers are very important in securing business because the share brokers are prohibited from making advertisement to solicit business.

Taravaniwalas and Brokers: Indian stock exchange has two categories of members namely Taravaniwalas and brokers. The Taravaniwala in India does the work similar to the *Jobber* in the London Stock Exchange. A jobber is a dealer in securities, while a broker is an agent of a buyer or seller of securities. Jobbers deal only with brokers and not with the public whereas the broker is a middleman between the jobber and the real buyer/seller. But Taravaniwalas in India have been found to play a double role of broker-cum-dealer.

Clearing House: It is an agency that performs the task of arranging for delivery of securities and their payment by the concerned parties. The clearing house pools together all the bargains made by each member of the stock exchange so as to find out the result position and it traces the ultimate buyers and sellers of securities to put them in touch with each other. The clearing house thus simplifies and expedites the work.

OTCEI

The establishment of the Over The Counter Exchange of India (OTCEI) marked the dawn of a new era in the history of stock exchanges in India. The OTC Exchange is regarded a blessing for the small, both existing and new, companies and for investors, particularly small investors. The OTCEI which was incorporated in 1990 became fully operational in 1992.

The OTCEI is meant primarily to trade securities of the listed companies, like the other stock exchanges. It is, however, a stock exchange with a lot of differences with those of other. "Although the basic framework of the OTC Exchange is that of a *national market, yet there is no physical location, no counters, no trading ring, no stock exchange building and no hustle and bustle scenes as the conventional stock exchanges.* The buyers and sellers living apart from each other trade in corporate securities over the telephone. The system cuts across urban and rural areas extending the frontiers of the stock market to the entire country. These OTC markets are fully automated exchanges where transactions are completed through a network of telephones/tellers computers right from the first centre to the last centre. In addition, only professional people are authorised to render financial services."[5]

The OTCEI has been promoted jointly by ICICI, UTI, IFCI, IDBI, SBI Capital Markets Ltd., Canara Bank Financial Services Ltd., GIC and LIC. These institutions are sponsor members of this Exchange.

Over The Counter basically implies trading across the counter in scrips which are listed on the OTC exchange.

The term *counter* refers to the location of the member or a dealer of the OTCEI where dealing actually takes place. All the counters trade in all the scrips listed on the OTC Exchange. At every counter, an investor can see the quotes on the PTI - OTC Scan, complete a transaction, as well as ask for investor services. In other words, each counter acts as a trading floor of the OTCEI. Thus, as against a single trading floor in a regular stock exchange, there would be as many trading floor as the number of counters on the OTC Exchange.

Distinguishing Features

The OTCEI has a number of distinguishing features vis-a-vis other Stock Exchanges.

1. While other stock exchanges are associations formed by stock brokers, the OTCEI is a company promoted by Financial institutions.
2. There are many restrictions on listing on the OTCEI. Several types and categories of companies which are not eligible for listing on a regular Stock Exchange are not eligible on the OTCEI. Further, a company listed on any other recognised stock exchange in India would not simultaneously be eligible for listing on the OTC Exchange.
3. The method of price fixation differs between the OTCEI and other Exchanges. On the OTC Exchange the pricing of scrips is regulated. The market makers compulsorily offer buy-sell quotes which are based on proper evaluation of the company. In other Stock Exchanges, the share prices need not necessarily have any relation to the fundamentals. Speculation could cause wide price fluctuations on the regular Exchanges.
4. The OTC Exchange is a market for spot deals only.
5. On the OTCEI, the settlement takes place daily, unlike on the other exchanges.
6. The OTC Exchange permits automatic transfer up to 0.5 per cent of a company's equity whereas in other cases permission of the companies required for all transfers.
7. In the OTC Exchange, the spread does not exceed a specific percentage whereas in a volatile market there is no restriction on spreads.
8. The OTCEI is characterised by a decentralised working with national work. Other exchanges are centralised in nature, members operating from a single location.

Benefits to the Investors

The OTC Exchange offers a number of benefits to the investors. The important advantages of it from the point of view of the investors are:

1. Quick payment of money to the sellers and quick delivery of shares to buyers.
2. Price transparency: On the OTCEI, the investor clearly knows the buying and selling prices whereas he is not able to know the actual price at which the scrips are bought or sold for him in other stock exchanges.
3. The OTCEI saves the investors from other unscrupulous behaviour of the brokers.
4. Liquidity even for scrips of small and new companies.
5. Fair prices.
6. Simple procedure of buying and selling
7. Facility to sell even odd lots.

Benefits to the Companies

The OTC Exchange offers certain advantage to the companies also. The important benefits to the companies are that it:

1. Enables even smaller and less liquid companies to get listed.
2. Facilitate new issues at lower costs.
3. Makes raising capital through issues easy for small, new and closely held companies.
4. Helps create market for scrips of small and new companies.