Money and Banking

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Lecture - 32

The problem of RBI is as a monetary management authority, market policy authority is to maintain sufficient amount of liquidity in the system. If it is excess bring that out; like you require water, it is too much water drain it out. If there is a shortage of water, bring in water, so there is no shortage. Now with respect to liquidity that is availability of credit etcetera in the system, it has to provide as a mechanism to inject funds and withdraw funds, but with opening about the economic system is getting very complex. Now you are the export market opened, so lot of funds coming in also. Now for the export market to develop in the initial years, lot of funds are required for the exporters. Then you have said you have a free market economy industry can develop, so the firms need to borrow money, so funds need to be available for them at you know proper rate etcetera.

Now, this part is a discretionary liquidity, because the autonomous liquidity is something, which is autonomous, I mean it just has his own life. The amount of money that the rainfall, for instance, it you take the example of rainfall, monsoon provides the rainfall, we should not control. Now if rainfall is sufficient is good news; if rainfall is insufficient, you need to arrange for irrigation facilities. If rainfall is too much which we have seen in some areas like Assam then you have an another kind of problem. Now autonomous liquidity is like monsoon, now the discretionary part is within the control of the RBI what it should do. Now ILAF is a system, there initiated for one year in April 1999 with four kinds of instruments in the basket.

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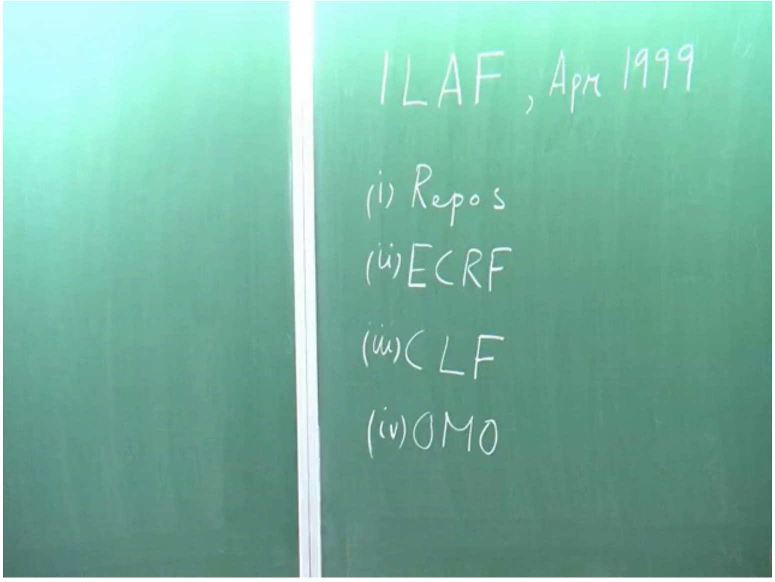

One is the Repos - they said these are market determined repos. Actually what is happening is, they are not market determined; the language is confusing; they are the repos are the repos are determined at RBI. The repo rates determined by RBI just know what it also does, it announces repo and refo s reported, but that determination process takes into consideration the market situation. I determine it, suppose I see in the market some kind of policies I need to maintain because of certain situations. So, I need a tight market policy. So, they would immediately raise the repo rates and the reverse repos.

Now you require relax policy, they would lower the repo rates; that means, basically what we saying banks you can borrow money from us at a lower interest rate; repo rates is what lower interest rate or when I take out money from you I give a lower rate. Now this kind of a market determined repo rates which is the language is confusing me initially, but I understood what it is the RBI determines it, but it takes into consideration the factors in the market present in the market.

Now repo is then that ECRF, I mention that ECRF. ECRF is an export credit. You can imagine export of if you remember the last course you took. The reforms had an emphasis on a few areas industrial licensing policies then they had emphasis on the trade sector liberalization. Then they had emphasis on MRTP; if you remember four five items I listed when the reform structural reforms I thought you in the previous course. So, exports have become very important now. Now this export credit refinance meaning what, banks if they are unwilling to give funds which they have always done even with respect to rural credit. Banks unwilling I am giving you the money; banks now you distribute the money and disperse them, at rates I tell you. Say for farmers if banks go about doing the business on its profit on the basis of its profit motive, it will not give money, it will give very little money credit, and also it will charge on the interest rate which is not affordable.

Now if you have to do a kind of social banking help of the farmers then the banks have to be told ok, ok, give money I will reimburse them or I will be refinance them. Particularly, in the case of default because you are giving to poor borrowers who may not returned the money. So, banks often reluctant neither export market is just speaking up now you have to develop the competitiveness in the international market not domestic. Domestic (( )) one kind of game, but now you are going into the international market, where you are competing with imagine the competitors. If the particularly if they come for the first (( )) even (( )) is a very big competitor. So, the export market is also a very uncertain place were banks would be kind of reluctant to invest initially at least and you imagine I am talking about 10, 15 years back 13 years back story. So, what they did was this RBI would export credit refinance facility they provided.

I will tell you a little bit about export credit refinance facility if I have it anywhere, No I do not have it here. (( )) Nope, but it is understood what it is, and the whole thing of open market operation is still there, but the funny thing about open market operations in India you did not come to me with that question I think I was thinking about you may be on (( )) after that. Borrowed, un borrowed deserve, I got stuck because I touched upon that many years back. I may have still in my notes a little bit, but not much.

Now the open market operations are what, is controlling money supply its a traditional market policy instrumental you see in your notes I have taught you. But the problem is that the open market operations in India very peculiar, when it went for open market purchase, it went to the market open market purchase when the injecting funds. And when they went for open market sale, I will show you the data it is coming up in this topic; it is primarily state governments.

Open market operations are two types purchase and sale in case of purchase; they are gone from the market, interactions. So, banks, non-banks everybody were there, public.

Open markets sale, when the funds are coming out of the system into RBIs pocket, sale of securities because when you selling security, you are getting cash back. So, money is drained out of the system, contraction in policy that was primarily with refers to state governments. So, state governments were like using that as an investment opportunity. It is not open market operation as a monetary policy; state government if they surpass funds, the best way to put the money in is government documents, dated securities because central government securities. So, state governments investing the surplus ones primarily in central government dated securities. So, is the open market operation in that sense very effective, the way it is used in other countries were these are traditional instruments. So, in India, the monetary policy instruments which are most effective seems to be the repo rates and the CRR.

Since to be not bank rate, not open market operations. The open market operations is seems to be its there in the basket. Go to the market just not always the state governments, so it is giving only the opportunities to the state governments to invest the surplus ones. If you look at the data, these things become clear when you look at the data, actual working of the system how it works. If you do not understand, we will have a discussion class on this before I start a new topic.

Now and collateralize lending facility, I have a huge amount of note here; I just pass on this notes to you. Let me tell you what it did, collateralized means what, banks can borrow against securities. Collateral is security; I would borrow funds from a bank loan, I show my property a flat, a land whatever I have collateral is lending banks to CLF. So, I go collaterals borrowing. Now CLF - collateral lending facility was available. Let me read out the few things just to have an impression in your mind; it will create an impression on your mind. You do not have to memorize this at least you look at my questions very some of it is the little bit, more problem most are not memorizing stuff.

CLF was available up to 25 percent, 25 percent of the fortnightly 25 percent of the fortnightly average outstanding aggregate deposits a banks in 1997, 98. So, 1997, 98 may whatever the outstanding aggregate deposits (( )). They would give CLF to the amount of 25 percent of the fortnightly average of that year. For duration of two weeks, no, no, not 25 percent, I am very sorry not 25 percent, 0.25 percent, 25 percent (( )) 0.25 percent; less than one percent. One forth of a percentage for you of the aggregate deposits they will give you as a collateral lending facility at the bank rate. Bank rate very interesting central bank rates I was telling you bank rate is offering the Bihar state very interesting. So, it is been given one fourth of a percentage for you of your aggregate deposits 97, 98 fortnightly averages would be given to a bank for a duration of two weeks extra funding from RBI to fund whatever.

And additional CLF; CLF and additional CLF which is called ACLF - additional collateralized lending facility of an equivalent amount was also met available to the bank at the bank rate plus two percent. Additional, you can also get an equivalent amount; that means, one fourth of the one fourth of a percentage point of aggregate deposits when aggregate deposits refer to 1997, 98 financial year can be given again to you at the interest would be the bank rate plus two percent more, because this is an additional facility to banks can be given. And I am reading out I will give to the notes. So, you do not have to memorize, you just have to listen to me.

And ACLF, I would beyond two weeks would be subjected to a penalty rate for two percent for an additional two weeks. So, if you have a CLF beyond two weeks then there will penalty rate of two percent. So, they are available for two weeks, two weeks; first CLF for two weeks one fourth of a percentage point of aggregate deposits. Given to you at a bank rate for two weeks not very short-term lending, money market lending by RBI to the banks. Now you need more cash, because this is lot of export finance whatever going on industrial finance, you are short of money, you give now too much loan too much demand for loan may be, so increase in the liquidity. Two more weeks will give the same amount, but the interest rate will be bank rate plus two percent. You have two more weeks that to be extended again a CLF then it will be penalty of two x two week. Probably it is not if you do not return money, but it is written with an additional of two weeks there will an extra penalty of two percent again.

Now, ECRF - Export Credit Refinance Facility which is coming to what I was trying to teach you even RBI lends the bank rate is the maintaining rate. So, that is also advantage given to the banks export facility alright. CLF bank (( )) additional CLF two percent plus bank credit. Then this money liquidity support against collateral government securities what RBI make this what I am going to teach you, this is the modern Indian era now after 1990. So, RBI is creating satellites. So, I am just (( )) sitting here, but I have created satellite cars you interact with them; you do not have to even come to me, they are called primary details now coming to that p ds. The famous primary (( )) in India is discount and finance head of India - DFHI.

So, this funding banks to that exist without come into RBI, they do not have to. RBI is kind of what you call that decentralizing its functions. Now what is the first thing – decentralized. Now this year they are also doing. So, they get the primary details and you go to primary details, and take the funds from them and I have given maximum and primary details when it does the lending very interesting is money for these purpose to primary over here the CLF a CLF to banks. Primarily, they have made them not kind of passive organizations; primarily there is risk, you make money, but money or by their name alright a CLF whatever, but when you go to money borrow money I give you money although you are my satellite organization, you will have to pay interest to me.

Very interesting, you will you have you could become conscious when you lend. So, that you have to earn and you have to lend efficiently. Primarily there is alike father asking the son if you borrow money form me alright you look after it, but you will have to give me this return, it is not costless. So, when you spend the money, you have to be careful when you give the money to your neighbor. So, primarily these were also asked to pay in something from interest rate. And you have seen repo and open market operations, they found based on the experience of ILF for a period of one year and in general group of that RBI we always have this and the internal group of a their consisting of the even the governors and the deputy governors or whatever, sometimes the governor himself or may governors and the deputy governors and board of direct directors, they form groups called working groups. Then internal group of RBI recommended phase implementation of full fledge liquidity adjustment facility, but it is very interesting how it came about final later.

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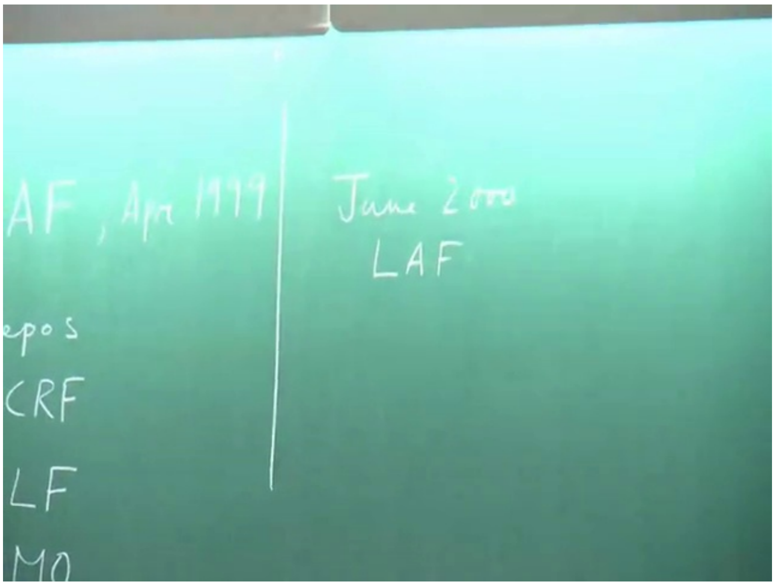

It came into existence in June 2000. ALF came which is still there, if you open RBI you get the repo reverse repo data top it is written under LAF scheme, here will be writing. This June 2000, it came this is the LAF. If you read the adjustment facility of the RBI (( )) internal group and you believe me LAF operates only through repo and inverse repo options of all transferable government securities, all that excess of course.