Indian Economy: Some Contemporary Perspectives
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Indian Economy - Monetary Policy 2

So, hi, everyone. Let us start the next session. So, we are talking about the monetary policy and we were talking about how we can understand the monetary policy better. So, some background I have given already. And I have also mentioned that how in the beginning we had to go for some structural changes in the monetary policy and it is a continuous process, so we have to evaluate ourselves well and then, we have to also think about the new changes that are happening around the world. So, we are trying to assimilate those changes in our monetary policy setup.

But there are certain things that in this particular session, we will be covering. So, first thing is that what are the tools of the monetary policy that we have? And if we are talking about the monetary policy tool, then it includes all types of interest rate it, it includes all types of reserve requirements that the bank supposed to follow. And then, I will take you through some historical developments that when we started thinking about the monetary policy then in the formative years then 1970s, ‘80s and then post 1990 onwards, what are the changes that the monetary policy had to experience and how it has evolved over time.

So, I have already discussed the simplest part was that we were talking about the price stability and then, we also saw that how from the single indicator, we have moved to multiple indicator and now we are thinking about the whole lot of economic indicators incorporating into the monetary policy.

I have also discussed the recent changes that we have made to the monetary policy as per the recommendations of the FSLRC Committee recommendation. So, according to that, now we have the monetary policy committee that takes care of the government side of the monetary policy requirements that government is supposed to convey to the RBI.

So, going ahead, in this particular session, we will be focusing on the basics. So, most of the time, I find from the students that sometimes they are not aware of these basic tools, how it is being used. So, in chapter 3, volume 2 of each and every economic survey, you will find that it is discussed in the context of monetary and financial intermediaries. And you will find in that you have certain indicators mentioned in the table.

So, those who are from economics, they are still able to understand those indicators. But those who are not from economics, those who are preparing for Civil Services or any competitive exam then they find it difficult to comprehend that what it actually talks about. So, I will try to shed light on those indicators so that, in future if you read any economic survey, especially for non-economics students, then it will be easier to understand and at least you will not have some kind of confusion. So, this is all about the monetary policy.

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For this, I have referred one very important document that I found, the committee was set up in 2011 and it was under the Deepak Mohanty. And has a document available on the RBI website. And when I went through, I find that quite informative in terms of the historical development that we had to undertake from the monetary policy side.

So, if some of you are interested in exploring further about the monetary policy history and how it has evolved and why we had to go for the liquidity adjustment facility? And what are the changes we should be incorporating? How repo rate became the indicator of monetary policy? Why it was replaced earlier rate of what we had the bank rates? Earlier bank rate was the measure, apart from the reserve requirements that banks had to maintain.

So, if you go through this particular committee report, then you find that you have a whole lot of information given. And especially I would recommend those who are going to work in the area of monetary economics, those who are going to have the interest in the monetary economics they can further refer to this document. Especially those who work in the area of monetary transmission wherein we look for what happens to the real economic activity when there are changes in rate of interest and with that change in rate of interest rates, so some kind of pass through process that we already mentioned.

So, it is also one of the objectives of the Central Bank that whenever they go for revision of the interest rate then they also monitor that how much the benefit the Central Bank has given in terms of rate cut? How much it has been passed to the masses in terms of how banks have reacted to that rate cut. So, over a period of time, you will find that banks always will mention that in this particular year we had gone for the rate cut by 100 basis points. And we found that the banks had passed this benefit by 75 basis points, 80 basis, so some kind of justification will be given in the economic survey volume two whatever chapter that discusses.

Then there are standard references Economic Survey 2016-17 2017-18 and also 2018-19. So, some portions I have taken out, I have taken from these two sources. But about the indicators that I am going to discuss it is available in any textbook, any source that you want to refer. But just to give you some kind of structured outline about the monetary policy instruments, I thought it is better that I should be discussing that.

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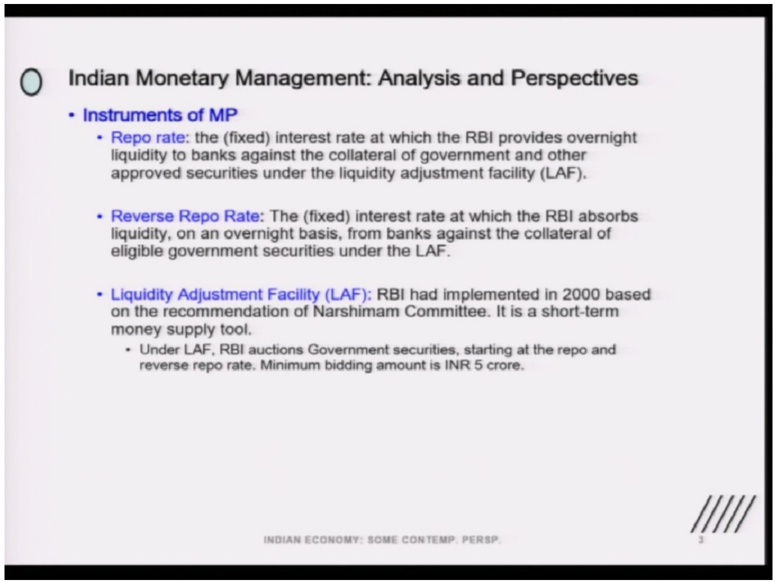

So, in the last session, we had also gone through these instruments. So, there is no harm if we can spend two to three minutes on this. So, one was the repo rate. We had gone in 2000 going for the Liquidity Adjustment Facility. So, what happens to that Liquidity Adjustment Facility is some kind of corridor of the policy rate, basically a repo and reverse repo. So, whenever we have the shortage of liquidity then Central Bank will lend money through the repo rate and whenever there is excess liquidity in the economy, then the banks will simply surrender their excess to the RBI on the reverse repo rate.

So, in this case in repo, since it is a repurchase agreement, so there is something to be surrendered, so in terms of government securities or any kind of collateral that you have to give. So, in repo rate, this is the requirement that the repurchase agreement it is or repurchase rate is that you are going to borrow from the RBI and then, you put some securities or some collateral with the RBI and this happens. And repo report is especially useful when there is supposed to be some kind of credit expansion.

So, in the sense that the banks are parking their securities with the RBI, RBI gives money to the banks and this money they will be using after meeting the CRR and SLR requirements for credit creation. So, this is one way of controlling the money supply in the economy. And then, you have the reverse repo, reverse repo it is that the banks are having extra money, then banks can buy the securities of the RBI and in turn banks will be paying to the RBI and in turn what happens that whatever money that banks will have, they will be surrendering to the RBI and as a result there will be less liquidity in the or some kind of liquidity adjustment in the economy.

So, whenever you have any day, if you go through any News Paper, you find that you have different types of news coming on the monetary policy committee how they are going to decide about and what will be the policy rate? So, if there is a repo rate cut down, it means that government is now giving more leeway to the banks that you should borrow from me at a cheaper rate and go for expansion.

In real life, this is one of the one of the questions being asked by many students when I teach in class that when we deposit money in the bank, bank offers us a lower rate of interest on our deposits. But when we borrow from the banks, then bank charges higher rate of interest. So, it is also linked in the same way with the RBI, when RBI lends money to the banks, it charges a higher rate of interest. So, right now it is 4 percent. But if the banks keep money when there is excess liquidity and banks want to keep money with the RBI, they will be given at lower rate of interest.

So, this spread that you have, it has to be compensated in some or other way. So, there are different windows to be open for the bank. So, that it is not just the repo, banks can also go for the bank rate, and also go for some other instruments which are available with them. So, liquidity adjustment facility became one of the important policy instruments with the help of repo and reverse repo. So, there is no as such liquidity adjustment facility. It is just that it is it creates a corridor, so lower and upper based on the repo and reverse repo.

It was recommended based on the committee recommendations that we have already discussed in case of Narasimham Committee. So, Narasimham Committee gave this particular recommendation that you should be going for the minimum amount of bidding is INR 5 crores. So, if you go on the RBI website, the front page, you find that this liquidity adjustment and this bidding amounts will be given whatever is the request coming from the banks. And since, these are overnight, so of course, those dates will also be given, the timing and dates of the bidding.

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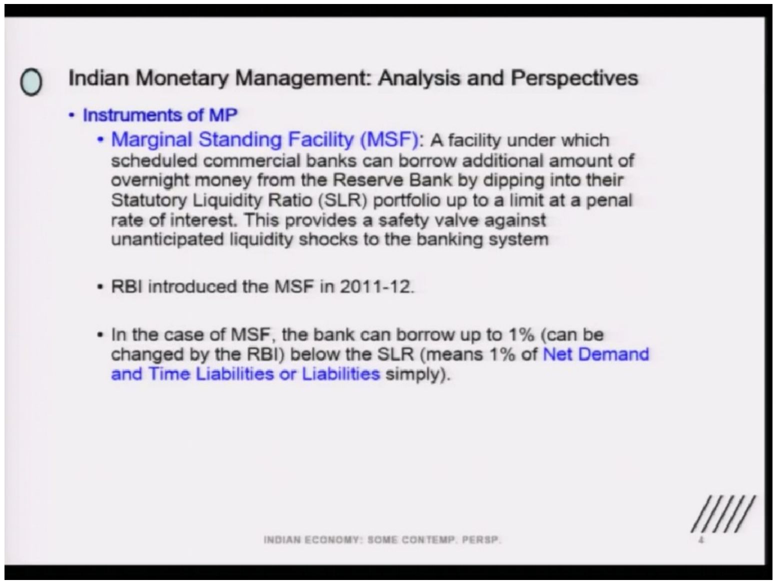

Then one more window is created for the banks to borrow from the Central Bank and it was created in 2011-12, it is called Marginal Standing Facility. And Marginal Standing Facility, if there is any kind of liquidity shortage, if Bank's feel they have already exhausted the option of borrowing from RBI and there is some kind of friction happening between whatever they want and how much it is available. So, they can always approach RBI through this window that is called Marginal Standing Facility.

It is it is a facility given to the banks to borrow additional amount of overnight money from the RBI and since it is an extra window, so bank should not compromise with the reserve requirements because they have to maintain the SLR ratio. So, as you mentioned that 1 percent of whatever deposit they have NDTL after adjusting the liabilities, they can borrow that amount. It cannot be more than that. So, that is also sufficient amounts. Suppose SBI if it is having the deposits of around 2 lakh crores, so 1 percent of that will also match some of the frictional requirement that they have.

So, Marginal Standing Facility, it was created in 2011-12 and especially, after 2007-08 global financial crisis, there was a lot of debate and discussion that how banks are going to meet the requirement whenever we have the excess stimulus package given. So how this will be supported? So, during that time also there was debate happening around and RBI introduced this in 2011.

So, this was also possible because we were in the quite the expansionary phase for a short span of time. And it will be felt that since we are expanding, so there is a huge amount of aid requirement and some time it comes for a very short term. So, it is better that those requirements should also be met. This also came in lieu of, we had the Basel Committee recommendations and Basel Committee also had given some kind of heads towards such type of arrangement.

So, it is all just to mention that in one line, this is just an extra window created for the banks so that they can easily manage their day-to-day adjustment in their liquidity requirements. So here, as I mentioned, it is also a safety wall against unanticipated liquidity shocks, which means that if bank suddenly they require 1000 core. So, they cannot generate money immediately, they will be approaching RBI through this Marginal Standing Facility. But the rate of interest will be slightly higher.

So, that I will be highlighting when I will show you the current rate that we have, so the rate pattern which RBI announced it also clearly mentioned that which one is cheaper, which one is costlier and how and why they have to go for?

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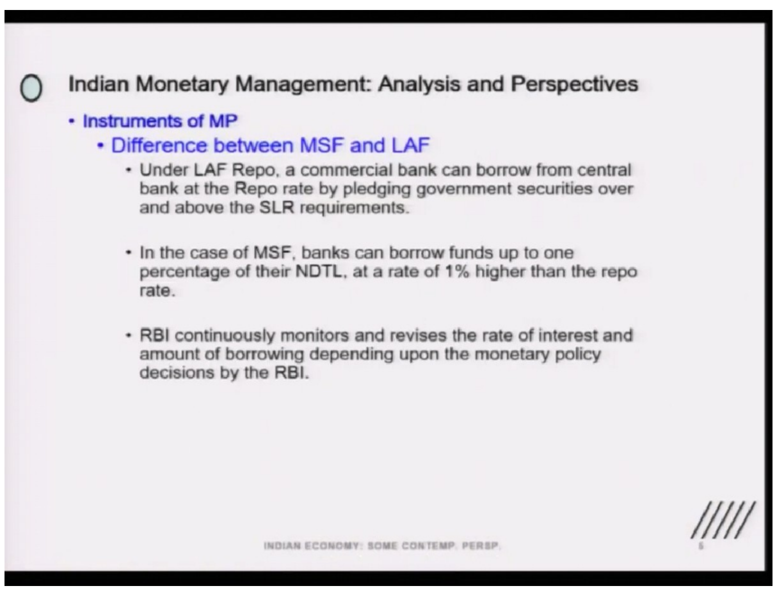

Then you may be asked by some experts or you may be asked in exam that what is different between MSF and LAF. So, LAF is just the Liquidity Adjustment Facility based on the corridors of the repo and reverse repo. And whereas Marginal Standing Facility, it is some kind of borrowing window as 1 percent of NDTL that I mentioned, SLR requirement that bank has to maintain and it is higher than the repo rate. So, 1 percent is not the exact requirement, it may be higher given the situation that banks and the financial health of the bank, this will be decided.

And the RBI continuously monitors the liquidity conditions. So, money supply conditions in the economy and that money supply will be adjusted with the help of LAF, Liquidity Adjustment Facility and also, with respect to the marginal standing facility. So, MSF and LAF are one of the important topics to be discussed.

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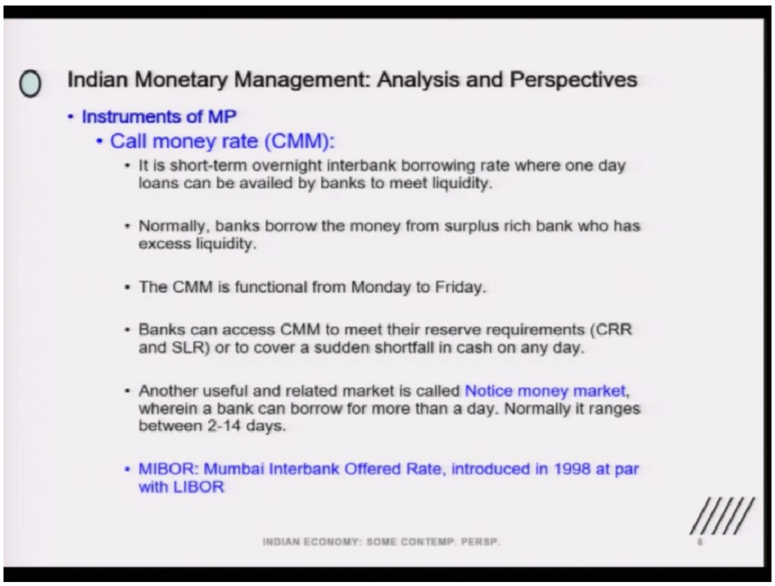

Then, this is between banks and the RBI. Now, we are going to look from what happens if suppose SBI is having the shortage of funds and then you have the Union Bank of India and Union Bank of India is having surplus fund. So, how RBI will ask money from the or will borrow from the Union Bank of India? So, this particular requirement it is also a well-developed market.

So, one of the reasons why we had to create the liquidity adjustment facility that at some point of time when we had only the repo and reverse repo and it was not clear that we should be the policy document. So, in officially a as part of the Committee of Deepak Mohanty, it was mentioned that that call money rate became one of the popular policy instruments. So, in each and every country, you find that there is a one policy rate.

So, in case of US, you have federal funds rate. So, in case of India, it was not very clear that what will be the policy rate that a particular single rate at which we will be going for a liquidity creation or liquidity adjustment in the economy. So, this call money rate is overnight borrowing and lending among banks. So, it is just that banks will participate in this and they will be having, but it depends upon the outlook of the economy.

So, liquidity in the CMM market depends upon the banking sector outlook. If all the banks are having similar kind of business conditions, then they will not be having sufficient revenue to put up extra amount of money on the call market for borrowing and lending. So, at that time, the relationship between bank and the Central Bank become really important. But in real life, when you have the normal business environment and you have the excess money created by each and every bank, which means that each and every bank is involved in into normal business, then in that case, it typically happens that banks will have a liquidity condition in the CMM market improves.

In some cases, you will find that this call money market is also important because most of the banks when they have a requirement for any kind of excess money, they will be participating through this or they can go through the marginal standing facility. So, if 1 percent of the SLR NDTL requirement, if they have already exhausted or if there is no chance to borrow, then they even go for the…

So, it depends upon the demand and supply. So, how much is available for lending and how many borrowers are there? So, rate is decided based on that. But there is also some kind of flooring that you cannot go for some kind of market creation based on your own buy and sell, there are some threshold given which is the repo rate.

So, CMM is functional from Monday to Friday. Banks can access CMM to meet their reserve requirement also. So, if there is any kind of adjustment in the reserve requirement, which means that there is a 1 percent or 2 percent requirement, so this requirement can be met through the CMM. Another useful and related market is called notice money market, where a bank and borrow for more than a day, normally it ranges between 2 to 14 days.

Now, this is for the domestic. So, let us focus on the international market also. So, there is something called London Interbank Offered Rate. So, London Interbank Offered Rate, it is the international rate at which most of the internationally or multinational banks they participate in borrowing and lending. And this rate becomes one of the important I would say, reference rate for borrowing and lending among banks.

In case of India also a similar setup was created in 1998 at par with and it was created with the consortium of 30 banks. So, Mumbai Interbank Offered Rate is also similar to the economy rate, but the only thing is that it is decided based on the adjustment with respect to the how much it is forward and how banks are participating. So, it depends upon liquidity condition, but MIBOR is also one of the important differences and it has been created on par with LIBOR. So that what we have.

So, for example, if Deutsche Bank want to borrow from the Bank of America or some other, so they used the LIBOR. So, we had in UK, we had a scandal also about the LIBOR how Royal Bank of Scotland had tried to manipulate the LIBOR rate. But in case of India, we have Mumbai Interbank Offered Rate because in Mumbai is the financial capital and there you have different types of very short-term requirements. So, those requirements are also met. This is also the overnight rate.

So, in this particular rate also you have the option of going for economy rate or the MIBOR. But there are some conditions that that if you want you can you and read about MIBOR. But normally, if you are working on the monetary policy area and if you are not getting the data on because the repo rate, it will not have the continuous frequency, even if it will have the continuous frequency then it will be simply going for 4, 5, 6, 7, 8, 9 or it may have the repeat of the number because whenever RBI will meet then only repo rate decision will be taken, revision decision will be taken.

But call my rate is a continuously traded market where you have the sufficient liquidity. So, in this case, most of the time you find that call money rate has taken as one of the proxies for the policy rates and where it is it is shown that how in case of whatever econometric analysis that you do, you try to incorporate this to see the impact of or the incidence of the monetary policy decision undertaken.

MIBOR is again one of the important tools where the firm’s borrowing and lending are decided. So, in most of the cases, the large amount of loan sanctions to firm if there is any requirement of liquidity, then banks will simply contract to another bank asking for that extra amount of liquidity. So, that is being also mentioned here. So, this is called call money rate.

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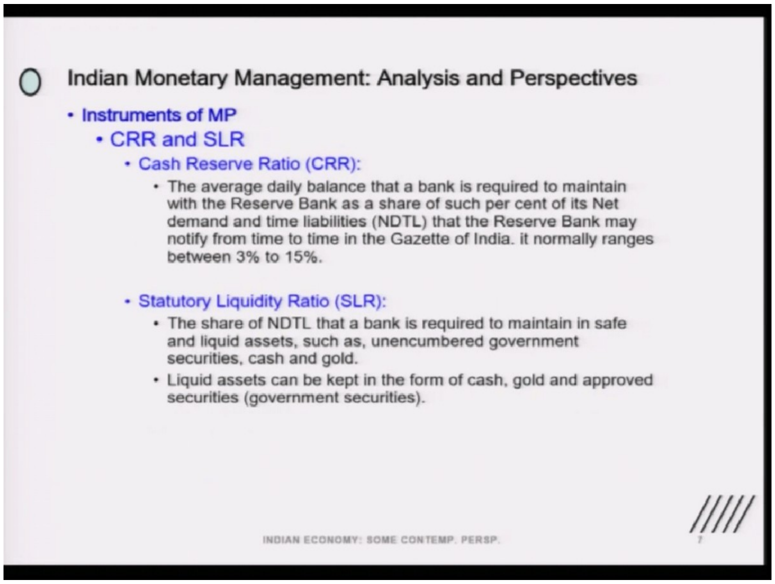

Then you have the CRR and SLR requirement. So, this CRR and SLR requirements are quite popular tools. So, since the 1960s we have been using it. So, we have already discussed in case of Narasimham Committee report that after the 1991 debacle, we had to go for the major revision in these rates. So, this is also one of the requirements to put a check on the banks that they do not compromise with their safety net, which also means that if you are going to save 100 rupees of money in the Bank, bank will first meet these requirements of saving, so keeping that money out.

So, suppose out of 100 rupees, 30 rupees is the requirement for SLR plus CRR. So, 30 rupees will be kept aside in the form of securities, gold whatever precious items that the government has prescribed for keeping SLR requirements. Similarly, the cash reserve requirement and then 70 rupees will be left for lending to anyone. So, if you are borrower and if you are going to bank asking for money then this particular amount will be given to you.

And since, the bank is also having one more task to do is that whenever the depositor is asking for money or withdrawing money bank cannot say no. So, you have the redemption also or some kind of withdrawal requirement also to meet. So, to keep those things in mind, banks decide about that how much out of 70 rupees it will be sold? So, there is some kind of excess reserves also created just to keep in mind.

So, after 2008-09, this has also been added. But these requirements are important to note because it puts a check on the feasibility of credit creation. So, if these rates are lower it means that more money is available to the bank and banks are then using that for lending. So, in case of CRR and SLR requirements are these. So, specifically if you want then it is the average daily balance that a bank is required to maintain with the RBI as a share of such percent of its NDTL and then the Reserve Bank may revise time-to-time.

So, it ranges between 3 percent to 15 percent. Earlier it used to be much because during 1960s-70s when government had very limited options to borrow, so CRR and SLR requirements were quite high and in this money was used by government to borrow from the Central Bank. But after that, when we had a when we had the expansion of economy, it created a lot of avenues for the government to collect taxes and all.

So now, this has been revised and then we had to also go for the economic globalization process going for credit expansion. So simple in a nutshell, if you want you can simply understand that if the cash reserve requirement is low, then banks will have higher cash for the lending. So, this is also one of the important determinants of what we call the money multiplier. So, money multiplier, in simple terms it is 1 upon the cash reserve ratio. If the cash reserve ratio is lower your money multiplier will be better and of course, you can go for the, so you have the circulation of currency happening quite fast, you can say distribution of money will be much faster. So, supply of money will be much faster.

So, cash reserve ratio is one of the important determinants of money multiplier. So, if you read economic survey, there will be always a plot of showing the money multiplier scenario that how money multiplier has gone over a period of time. But this also depends upon the cash reserve requirement.

Statutory Liquidity Ratio is the SLR requirement and this is also the bank has to maintain the certain amount of deposits in the form of safe assets, securities you have the cash and gold, so it can be kept. HDLs are also allowed, so HDLs can also be kept. So, HDLs means that the bond issued by the states, so that also become here. So, it is not just the union government securities or the security issued by the RBI, it is also that you can also use the HDL bond So, I will be discussing that after this.

So, this SLR requirement becomes one of the important requirements for the banks to keep in mind that, that if the SLR rate is high banks are supposed to keep the higher amount of money in the form of securities, in the form of precious metals or in the form of cash. But if it is lower, it also gives the indication that money supply is going to increase. So, there is an inverse relationship. So, if the SLR requirement is going to be low, the money supply is going to be high, if SLR requirement to be high than money supply is going to be low. So, this is how you have to understand.

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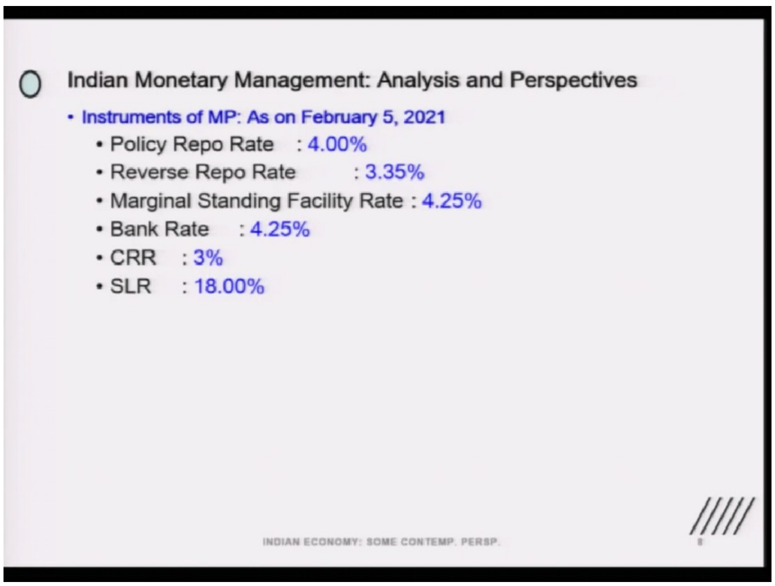

So, let me just give you the overall background whatever we have discussed. So now, you can see as on February fifth, 2021 we have the policy rate which is the repo rate it is 4 percent, then we have the reverse repo rate it is 3.35 percent then, we have the marginal standing facility 4.25 percent, bank rate 4.25 percent, cash reserve ratio 3 percent, statutory liquidity ratio 18 percent.

Now, let us compare for one second. So, here we have the policy rate which is 4 percent. Reverse repo rate, so at this rate the banks will be borrowing from RBI, they have to pay 4 percent. When banks are keeping their money with the bank they will be getting 3.35 percent, which means that reverse repo rate will always be lower than the repo rate. Then the marginal standing facility, which is higher than the repo rate, it means that if you are not going or if you have already exhausted your securities to be kept as collateral and if you have exhausted the option of going through the policy report, so you cannot borrow infinite amount of money through policy repo rate.

The marginal standing facility rate if you are going then you are supposed to pay 0.25 extra rate of interest on that. So, banks will be paying extra rate of interest, if they are borrowing from the RBI. Similarly, the bank rate, since bank rate does not require any collateral. So, bank rate is simply the rate at which bank banks can borrow from the RBI. So, this rate will be higher than the repo rate. So, you can see repo rate is 4 percent, bank rate 4.25 percent and 0.25 that RBI is seeking or asking from the banks, it is just that it is not non collateral. So, there is no repurchase agreement attached, this is just the rate.

Now here, these two are the money supply important indicators. So, you can say CRR which means a 3 percent, which means that as I told, the money multiplier 1 upon R, so R is going to be lower, the money supply is going to be higher. So, this is how it looks like that in the recent period after COVID-19 when government has gone for a major monetary policy expansion, the Central Bank has also cut down the rate of interest, which means that money multiplier is now happening quite fast.

And SLR requirement also. So, SLR requirements are also quite easy to understand that, if this particular rate is going to be lower, banks are going to have the higher money available for the lending. So, this is having direct linked with the with the inflation rate. So, if these rates are quite attractive, if money is being pumped in the economy, higher money supply is there, then there is a high chance that this will create the inflationary pressure. So, in turn, after some time Central Bank will increase these indicators.

So, these are the monetary policy instruments. If you read the documents of the chapters of the economic survey, you will find this thing mentioned. After this we will have different types of money that we are going to discuss. Thank you. Thank you so much.