Indian Economy: Some Contemporary Perspectives
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Lecture No. 31
Indian Economy - Monetary Policy 3

So, hi everyone. So, we are now going to start the lecture on the monetary development. So, we are talking about different instruments of monetary policy that the Central Bank decides. So, let us get into that and then, we will be talking more about the policy instruments. So, we are left with 1 or 2 instruments that the Central Bank is having that are linked to the recent development that we have.

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And so, this is lecture 31 and in this, we have the economic survey, I referred to 2018-19, 2019-20, 2020-21. So, 2020-21 it is available on the Ministry of Finance website, if some of you are interested you can access that. And as I had mentioned in the last lecture that I have referred this working group on the operating procedure of monetary policy by Deepak Mohanty, so, I will also again be referring here. So, in the last session, I was not able to refer. But here, I will be referring.

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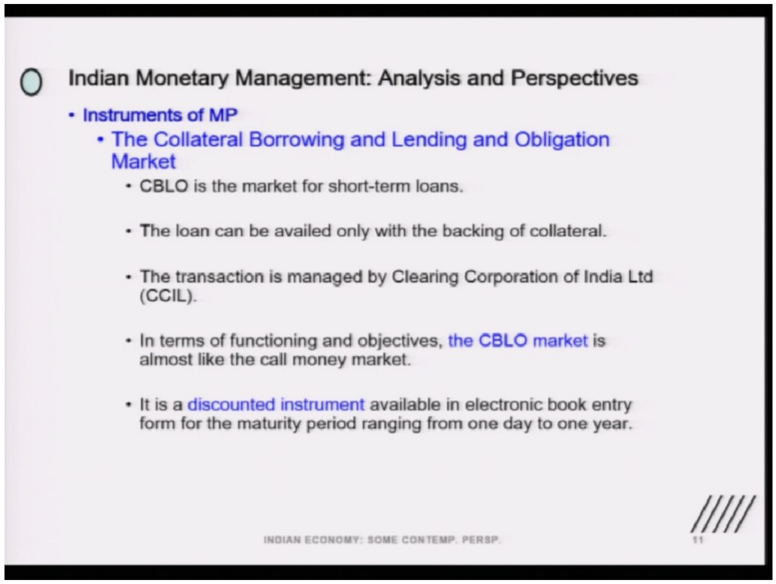

So, here it is the Collateral Borrowing and Lending and Obligation Market. So, in this particular market, it is called CBLO market and this is the market for short-term loans. So, similar to what we have the repurchase, in this also you have the collateral requirement and this is managed by the Clearing Corporation of India it means that it will be managed by third-party. So, if there are borrower and lenders they will be under agreement and whatever agreement that will be decided whatever they will agree on, it will be monitored by the by the Clearing Corporation of India.

So, Clearing Corporation of India also helps in the facilitation of the financial market especially the futures and the options, whatever futures contract that you are going to buy and whosoever is the seller, there will be some kind of margin requirement. And those margin requirements are monitored by the clearing Corporation of India. So, Clearing Corporation of India is having a large role in settling the contract.

So, in this also since, there is a collateral requirement and there is involvement of borrower and lender, so the CCIL role becomes really crucial. CBLO is the same as the call my rate which means that banks will be participating and there will be also a requirement of collateral. So, this is one of the important instruments to be introduced in the monetary policy as well, where the Central Bank will have the role in terms of whether the contracts and collateral requirements are met or not.

And that is why our, and it is also the discounted instruments, which means that in terms of you can think about if you are going to borrow and how much will be the collateral value based on that it will be decided. And it is also some kind of I would say quite not just overnight, it is also for quite not very short-term, but long-term also borrowings. So, it goes from one day to one year, which is very rare to get. So, if banks are not able to find sufficient liquidity in the call money market, they can also explore this CBLO market.

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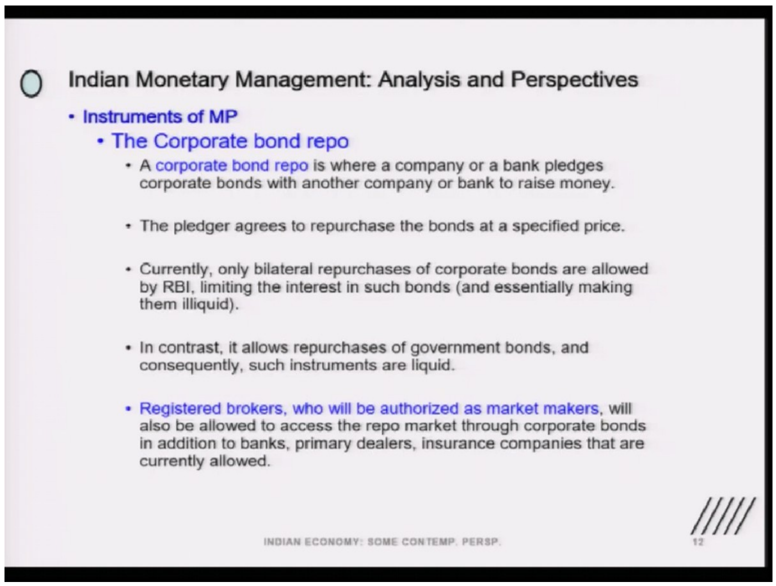

Then in order to give boost to the liquidity in the corporate bond market, now there is something call Corporate Bond Repo. What is this Corporate Bond Repo? So, this corporate bond repo is a is an instrument where a company or bank simply will have the contract or it will simply surrender or it will put the corporate bond as a collateral with another company or bank to raise money, which means that apart from the government security, so in case of repo you have to surrender the government security, the state development loan banks or some kind of securities traded on guilty security market.

Guilty security market where you have the open market operations happening. So, but for the first time, since in India we do not have the corporate bond market developed. So, the companies which are really doing good and at par with the public sector units or they have a good financial health, if they want to borrow they will be issuing corporate bond and this corporate bond may act as a collateral for borrowing. So, there is a repo, so repurchase agreement.

So, the borrower, whosoever is rendering those corporate one they are supposed to buy back. So, here it is mentioned that the pledger agrees to repurchase the bonds at a specified price, which means that if you are going to send us a bond there will be agreement that we will be buying back at this price. Whatever will be spread that will be the gain.

Currently only bilateral repurchase of corporate bonds are allowed by RBI limited the interest in such bond, which means that if I am the borrower and if I have given you the corporate bond as collateral or I have gone for pledging the certain corporate bond requirements as a collateral, then I am supposed to buy back it is not the case that even if I am not going to buy back, then this particular institution can sell to someone else, that is not requirement, it is just between the borrower and lender, whatever is the agreed price you have to go for settlement.

It allows the repurchase of the government bonds and consequently such instruments are liquid. Registered brokers who will be authorized as market makers not the market destroyers will be also be allowed to access the repo rate market through a corporate bond. In addition to banks, primary dealers, insurance companies that are currently allowed.

The only concern is that in the corporate bond market, it should not be that some speculators are playing a role and they may create the adverse scenarios for the lender which means that the most of the brokerage houses in Mumbai and on the Dalal Street you will find that they are in need of very short-term borrowing and in the panic when they feel that they are going to lose a huge amount of money, then it may happen that they may access this route. And as a result, there will be contract failures that we have seen the repurchase failures that we have seen in case of IL&FS. So, those concerns are there.

Second thing is that, there is a bilateral repurchase happening only between the borrower and lender. So, that is also one requirement. But going ahead, these initiatives may create a very good market for the corporate bond and then, it may also be allowed certain fraction for the smaller firms and business houses. So, that they can also participate in this.

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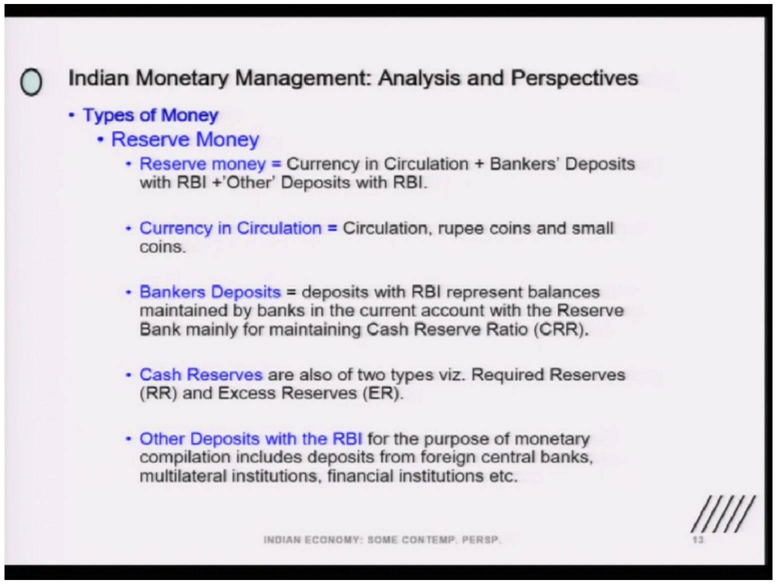

Then we have the types of money. So normally, if you read economic survey, you will find that they will be talking about the reserve money, they will be also talking about the high-powered money, they will also talk about the narrow money so, those things I will be discussing. So, reserve money it is normally whatever we have the currency in circulation, so, whatever cash or notes that you have in your pocket, the bankers deposit with the RBI, whatever the bankers are going to deposit and other deposits with RBI.

So, currency in circulation means currency rupees coins and the smaller coins that you have. So, whatever you have the hard cash. Bankers deposit that we have deposit with RBI represent balances maintained by banks in the current account with the Reserve Bank mainly for maintaining cash. So, whatever CRR requirements they have to maintain with the RBI, whatever cash reserve requirement that they have to meet. So, those are the bankers deposit.

Cash reserves are also two types required reserves which means there is the cash reserve. Excess reserves it is just that if banks feel that they have some amount of liquidity available and it may happen that the goings forward scenarios are not very suitable. So, they may keep these. Other deposits with the RBA for the purpose of monetary compilation include deposits from the foreign central banks, multilateral institutions, financial institutions, etcetera. So, whatever the deposits that you have with RBI. So, this consists of what we have the reserve money. Reserve money, which means that currency in circulation plus banker's deposit with RBI plus other deposits with RBI we include in this.

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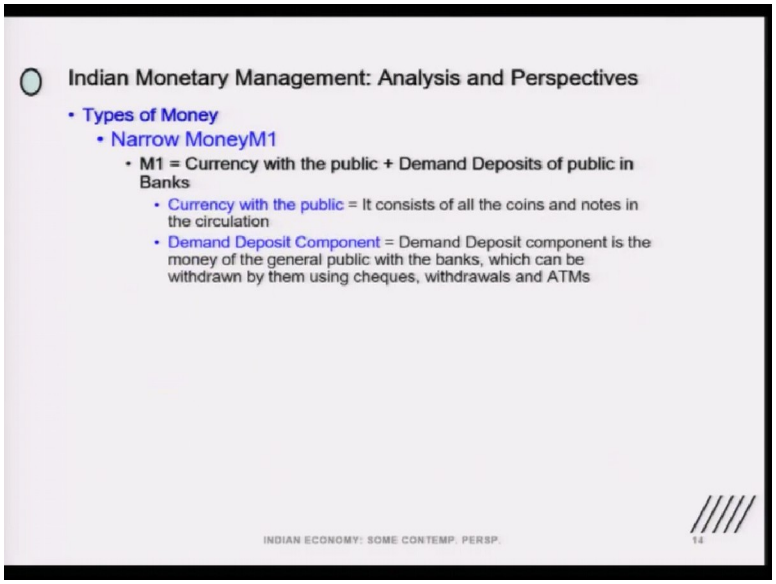

Then we have the narrow money. Narrow money means that it is in terms of whatever we have the higher liquidity scenario. So, we have the currency with the public plus demand, demand deposits of public in bank. So, you have two types of money, one you have the currencies and in the recent period you are going using any portal for making payments your debit card will also come into. And demand deposits, which means that you are keeping some amount of money in bank in terms of getting some rate of interest on that. So, this may be in a fixed deposit way.

So, currency with public it consists of all the coins and notes in circulation. Now in the modern era, we are using cards and all and even some payment apps. Demand deposit component, demand about component is the money of the general public with the bank, which can be withdrawn with them. So, which means that you are keeping some amount of money with the banks, but not for the tenure duration deposits, which means they should not be the fixed amount because on fixed amount you have a certain requirement that if you withdraw then (10:05).

So, whatever you have the amount saved in your savings account for certain days and you have the full capacity whenever you want you can withdraw that. So, that is what is called the narrow money. It is also called M1. So, narrow money is basically M1.

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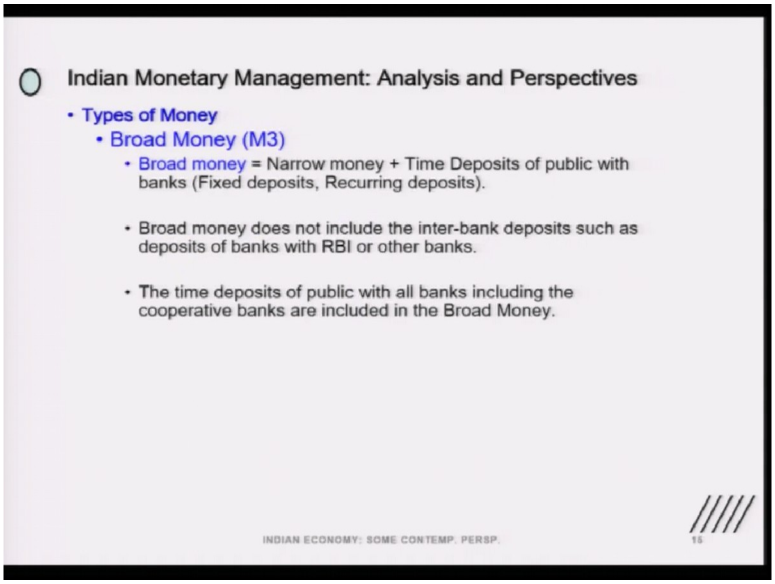

Then you have the broad money and broad money impact the money multiplier in the economy because it consists of narrow money, so M1 plus the time deposits of public with banks, including fixed deposit and recurring deposit, so if you have recurring deposit, that after some point of time per month you will be savings amount of money; once it reaches some amounts, the duration may be for 6 months for 1 year, then it will come back to your account and then again, you can go for recurring. So, that is called recurring deposit.

Fix deposits in the sense that you are keeping your money for 1 year or more, 2 years and then banks will be giving the rate of interest on that. So normally, it hovers around whatever is the deposit rate. So, these days now, we have the monetary policy going for expansion phase. So, during expansion phase rate of interest will be lower. So, if the rate of industry will be lowered then fixed deposit is not very attractive option.

So, these days you might be seeing on your television and everywhere even for every game you have the mutual fund advertisement coming. So, mutual fund is also one saving instrument. But in mutual fund also there are different types of funds. So, those risk involvements you have to understand and then only go for. But fixed deposits are risk free. So, there is no risk, the only thing that you will be getting a lower rate of interest.

So, most of the old age people those who are or pensioner they would like to go for these fixed deposit route because this particular route gives them a particular saving channel and some rate of appreciation on their savings, hard earned money. But during the expansion phase, when the rate of interest is lower, they lose some amount of money because bank will not be giving them higher rate of interest. So, that is why in every budget and whenever we have the budget coming they announced that if the senior citizens are going to save, then they will be given some amount of extra additional rate of interest attached with that.

So, this broad money is important because of these two components as I mentioned, fixed deposit and the recurring deposits. It is being used for interbank deposits also. So here, in case of broad money, interbank deposits in the sense that if you are keeping your money in one bank and even you have gone for keeping in, suppose you have the SBI and you have kept in the UBI, then those things will be added separately, it will not be that you just club. So, divisor banks with the RBI other Bank, the time deposits of public with all banks including the cooperative banks are included in the broad money.

So, even the smaller banks in rural areas, you may not find SBI, but you have the cooperative banks, and these cooperative banks also provide the similar set of services. So, those savings whatever is in the deposit form, this will also be added to the broad money. So, broad money gives you the overall picture of the money supply in the economy and money availability in the economy. So, this you have to understand.

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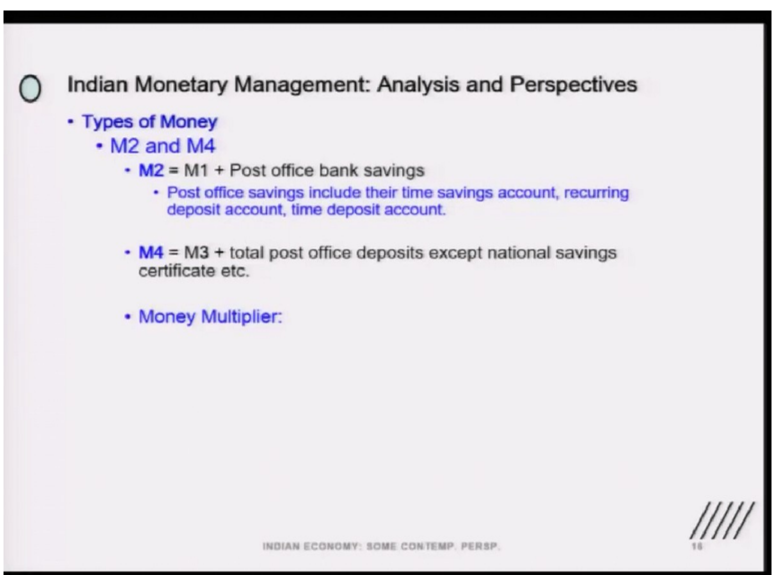

Then here we have the M2 and M4, M2 is M1 plus post office bank savings that we have. So, post office saving include the time deposits, then recurring deposits and time deposits account. So, post offices are also helpful in terms of giving options for saving to the individuals. And this particular route is also important to understand, so M2 becomes the high-powered money also that we always mentioned. And then in M4 you have the total Post office deposits except National Savings Certificate.

So, in the case of Post office one instrument is very popular that if you go in Post office and open an account for savings, if you want to get deposited some amount of money on the regular basis then this is also available. But there is also one instrument which is a widely popular among the solid income class is that there is a tax saving instrument. So, these are the government bonds, which is nothing but the National Savings Certificate, it is called NSC. So, it has the maturity of 6 years and it some time goes by the revision of the government, the duration.

But it is some kind of bond. So, once you come under the agreement that you will be buying this, this National Savings Certificate for 5 years or 6 year, whatever is the majority, it will mention in advance that on the maturity whatever you are going to save for 5,000 or 6,000 per month, after maturity you will be given this amount, which means that this is also the risk free asset, there is no risk attached.

So, if you want to save money you this is also one of the options and you will be given the tax benefit under ATC because whatever money that you save and if there is lock-in period of 3 years and if you are not withdrawing for three years that amount, then you are entitled for tax ATC what we say relaxation. So, once we have the ATC relaxation it means that if you are salaried class, you can use that saving for your tax deduction so, that will not be part of.

And in the same way, we have the money multiplier as I told, that it is also decided based on the cash reserve ratio. If the cash reserve ratio is lower, you have the better multiplier scenarios if it is higher, you have the lower multiplier scenario. So, higher money multiplier it means that it is leading to a more creation of money, inflation will also rise. But you have lower than it means that there is a multiplication happening at a very low rate.

So, this is all about the velocity of money that we always mentioned that how rupee or suppose your 100 rupees, how frequently it is changing the hand. If it is frequently changing the hand, it means that it is creating at every stage some amount of money, which means that everyone is now having some amount added and if everyone will have the money frequently, then this will lead to increase in prices, because then these 100 rupees will be used for buying some asset then someone else will be buying some asset.

Ultimately you will have more demand and more demand scenario created and if it is not equally matched by supply, which means that if we have for example, vegetables, vegetables are not coming in sufficient supply. But everyone is having money, they would like to compete and they will be buying at higher price. And once they buy at higher price your inflation will be higher. Once price will be higher, then Central Bank will again go for raising the SLR and CRR requirements, so that money multiplier becomes lower.

So, these are the concept for those who are from economics, you can understand these things in a much better way. Those who are from non-economics, so for them, I have added these two things. So, I hope this is going to be useful.

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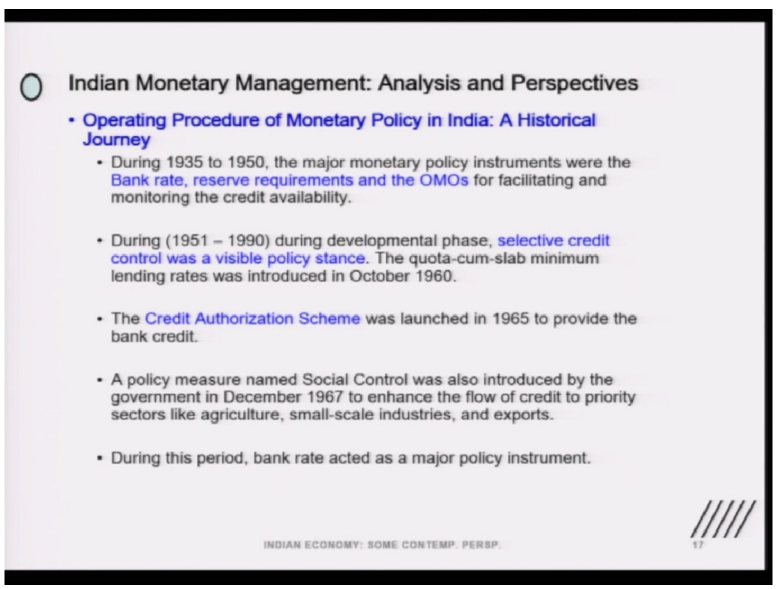

When I was going through the Deepak Mohanty report, I found this particular development really useful for my own understanding also and for the understanding of others. So, in the formative years, before independence, so 1935 to 1950, so at that time, we were having a very low capacity in terms of absorption of money supply. So, at that time, the government used to have the bank rate which means that there is no collateral requirement for the banks to borrow from the Central Bank. Reserve requirements were there.

So, each and every bank had to maintain the reserve requirements and the open market operations where the buy and sell of government securities are taking place and RBI is facilitating that some monitoring happening. So, the money supply is also getting adjusted with the buy and sale of securities. The bank rate was given because at that time there was no repo rate. So, we are in the 1947 - 1948 period, we just got independence and even before that the mindset was that we will be going for planning process and we will have the planned development. And that is why we had set up such type of infusions so that it creates extra space for the expansion of that particular setup.

So, at that time, bank rate, reserve requirements and OMOs, open market operations were the major facilitating and monitoring in terms of credit ability. So, credit expansion was dependent upon this. During 1951 to 1990, so this era, you can say, we had the Green Revolution and then we had the era of high regulations in the industry then we had a phase wise liberalization process happening in mid-1980s till 1990. So, till 1990 so these are the developments.

So, during this development process, selective credit control was there. So, you have the quantitative credit control and then you have the qualitative credit control. Qualitative, it happens that in case of quantitative control, you have the overall money supply in mind. But in case of qualitative rate control, it happens that you will be targeting some sectors. So, government is having something in mind that this particular sector should be given extra money for example, MSME sector, for example, you have the manufacturing sector so, some priority sector will be given. And this priority sector will be given extra incentive.

So, in this period in the beginning, in the 1960s, this credit control what is called selective gate control, was the policy as I would say stance of the government. Then we had the quota cum slab minimum lead lending rates which means that the banks can also go for borrowing from the RBI with certain amount of adjustment in the SLR, but if they go for beyond 200 percent or so, then they are supposed to pay a higher rate of interest. So, once they borrow from the Central Bank, then only they will be using for disbursement. So, some kind of adjustment was there and it was also introduced in October 1960.

Then we had the, then we had the Credit Authorization Scheme. So, if the banks are going to borrow from RBI even rupees 25 lakhs also then they are supposed to go for some kind authorization. So, this was also given to the bank credit. So, it was launched in 1965 but, after that we had to go for the heavy investment in agriculture. So, Green Revolution was taking place. So, at that time, we wanted some kind of liberalization process.

So, in 1969, since we thought that the priority sector lending is not going to be met and whatever the planning objective was there, the banking sector was not very supportive. In 1969 we had gone for nationalization of bank under that Punjab National Banks and all other banks were nationalized at that point of time, we have already discussed that in detail. So, a policy major name social control was also introduced by the government in December 1967, because it was found that there are banks available, but these banks are not helping the government to implement policies.

At that time, the social control policy was implemented, just to make sure that the sector's which were more vulnerable to the credit creation of the banks, they should be given proper support. So, at that time, agriculture, small scale industries and exports were given priority is that banks were directed that you have to give higher credit to these banks. And at that point of time, one more thing, it was experienced that these reserve requirements because government had limited avenue except that they can go for borrowing from IMF and World Bank.

So, except borrowing, the government had limited option to mobilize the fund to meet the expenditure requirement. So, reserve requirements were kept at a very high rate. So, even 30 percent more than 30 percent while the was there, which means that the banks will have a limited money for credit creation and this government, whatever money will be kept in the form of SLR requirement and the CRR requirement, this money will be used by government for extending the credit expansion in certain areas for the government expenditure.

So, during this period, the bank rate acted as a major policy instrument and since this particular instrument was the only policy rate, so if somebody will ask you and anyone in the exam that pre-1991, a period of 1990, which policy rate was the most predominant, so, it is the bank rate. Now, we talk about the repo rate, but at that time the bank rate was a major policy instrument.

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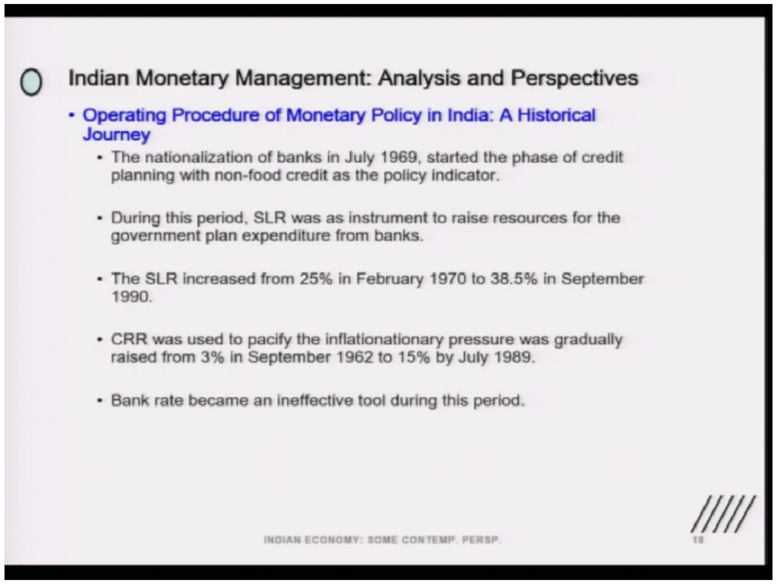

The nationalization of banks in July 1969, started the phase of credit planning with non-food credit as a policy indicator. Now here, after the 1969 nationalization of banks, we started looking at food credit and non-food credit. Food-credit, the loan which is given to Food Corporation of India to go for procurement of food grains, food items, at the minimum support price, that is called the food credit.

Non-food credit which means that all the activities non-agri activities or the activities, which are not linked directly to the agriculture and food processing, it will be there. So, non-food credit basically that it is all talking about industries, loaning and other credit expansion. So, in post nationalization of 1969 when we had gone for nationalization a bank this started. And as we know that SLR was the instrument to raise resources for the government plan from the bank. So, this was also there.

So, during this period, especially during 1970s, when we were also experiencing major we had the oil crisis and then we had the war with Pakistan at that point time and then, we had the Bangladesh this creation. So, at that time, the domestic scenarios were not very favorable. We were experiencing higher deficit we had to go for making expenditures. So, at that time SLR requirements were increased from 25 percent in February 1970 to 38.5 percent in September 1990.

CRR was used to pacify the inflationary whatever we had the pressure and it was also increased from 3 percent in September 1962 to 15 percent by July 1969. And this has also created a lot of extra pressure on the banks. So, banks had limited money to create go for credit expansion. But at the same time, these higher rates had also given a government extra buffer to go for out to meet the social objectives or whatever they had.

So here, the SLR and CRR requirements became the dominant and bank rate became the ineffective tool. So, during 1960s it was the period of the bank rate was the major, but SLR and CRR became the popular instruments of monetary policy during the 1990s.

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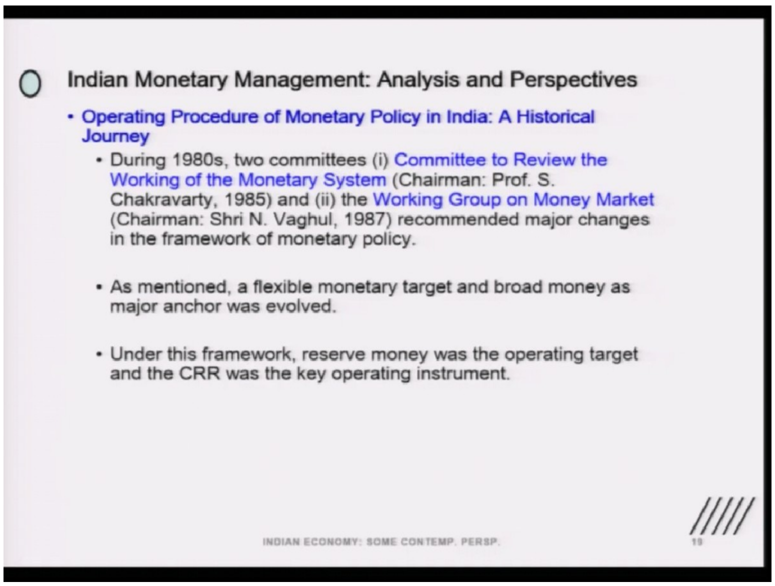

Then, during 1980s we had two committees, committees to review the working of the monetary system by Sukhamoy Chakravarty that is popularly called as Chakravarty committee because this committee had recommended for inflation of 4 percent tolerable inflation that we have already discussed.

Then there is also a working group on the money market by Shri N. Vaghul in 1987 recommended major changes in the framework of policies, led by price stability, but if we are talking about inflation, then what should be the policy target for the inflation? It should not be so high and so low that, if it is so, low buyers will be discouraged to sell in the domestic market. The suppliers or producers will be discouraged. If it is so high then it is impacting the buyer. So, keeping that in mind this Chakravarty committee in 1985, it had recommended for 4 percent.

So, we had the flexible monetary target and broad monies. So, M3 became the major anchor and it was involved. Under this framework, the reserve money was the operating target and the CRR was the key operating instrument. So here, the reserve money that we just talked about, it was the operating target which means that to meet that and CRR was the operating instruments, which means that the higher and lower CRR will lead to increase or decrease in the money supply. So, these two committees are important.

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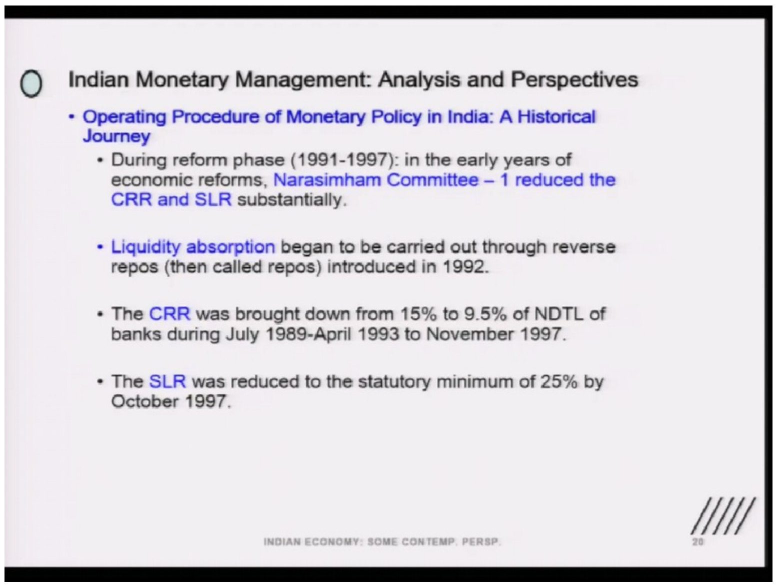

Then, during the reform phase, in the early years of economic reforms, we have Narasimham Committee-I, it has reduced the CLR and SLR requirements substantially. So, this we have already gone for. And this CRR was down from 15 percent to 9.5 percent and it had happened during 1989 to 1993 and it had also happened in 1997. And SLR wall was also reduced from 25 percent, a minimum of 25 percent which means that from 38 percent, it came down to 25 percent. So, these two that we have already discussed, when we were discussing the banking sector reforms, it had also changed the route of the monetary policy.

So, this was there and so whatever we have we have discussed so far, I hope it is useful for those who are from non-economics and those who are from economics also that how over a period of time the policy instruments have changed the course of the economic development and how the economy development whatever objectives were there, they were also quite focused on the banking sector expansion. And the monetary policy was also adjusted accordingly. For instance, during 1970 CRR SLR requirement becomes a prominent. Before that it was bank rate and then we started focusing again on the CRR SLR requirement.

So, these all also led to what we have the change of the course of the banking sector. And in the next session, we will be continuing with the recent development. Thank you. Thank you so much.