

Economics Class 08

24th July, 2023 at 9:00 AM

INFLATION DURING COVID (9:00 AM):

- During the Covid lockdown, demand was very low.
- As the supply chains were broken, the cost of production of many products increased.
- This also caused **cost-push** inflation.
- As we saw the effects of the disruption of global supply chains, India started the **Atmanirbhar Bharat** Mission.
- After the lockdown restrictions were released and RBI practiced expansionary monetary policy (less Repo rate).
- The government also launched many direct benefit transfer schemes.
- As a result, the **pent-up demand** increased.
- Due to a sudden spike in demand, we also saw **demand-pull** inflation.

Liquidity Adjustment Facility (LAF):

- LAF is a facility extended to the banks by RBI to tide over temporary mismatches in liquidity.
- At any given time, the bank may have excess deposits over the credit demand or the credit demand may be more than its deposits.
- In such cases, RBI, being the banker of the banks provides a liquidity adjustment facility.
- If banks need money, RBI lends it to them for a short term at a Repo rate.
- Conversely, RBI also borrows from the banks in case banks have excess deposits over credit demand.
- Such borrowing takes place at the Reverse Repo rate, which is less than the repo rate.
- Repo and Reverse Repo operations take place through buying and selling of government bonds, and an agreement to repurchase them within a short period.

Credit Control by RBI:

- RBI uses quantitative and qualitative tools to control the amount of credit or money supply in the economy.
- Quantitative tools focus on the overall credit or money supply, whereas qualitative tools focus on **selective credit control**.
- This means selectively encouraging or discouraging credit for certain sectors.
- Quantitative tools used by RBI are as follows:

I. Repo Rate:

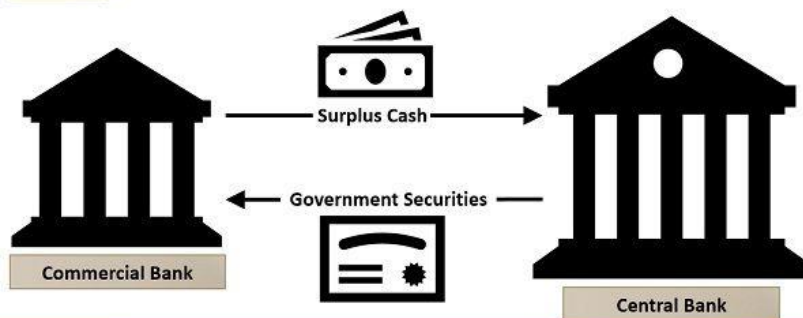
- It is the interest rate at which RBI lends money to banks and other financial institutions.
- In repo, there is a "repurchase agreement" that the G Secs would be repurchased by the bank after the loan period.
- The repo rate is a short-term instrument, generally of one day.
- Generally, the Repo rate is used as the policy rate except during Covid when the policy rate was shifted to the reverse repo rate.
- If the repo rate increases, then the money supply decreases.
- Because in this case, banks will reduce giving out loans and divert their funds to paying RBI the higher repo rate.

II. REVERSE REPO RATE (9:30 AM):

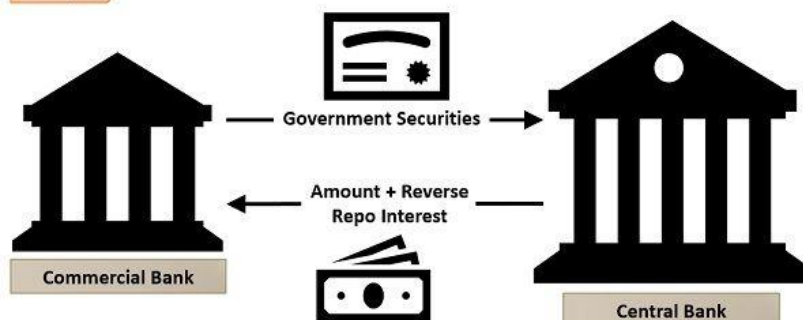
- The interest rate at which banks and financial institutions park their money with RBI.
- Earlier, the difference between Repo and Reverse Repo Rates was 25 basis points(0.25%).
- But currently, the gap between the repo rate and the fixed reverse repo rate has widened.
- Higher Reverse Repo rates would see banks shift their funds from the market(loans to people/companies) to RBI.
- The finance market follows a rule- **more risk-more gain & less risk-less gain**.

- RBI gives less rate of interest on the funds parked by banks (reverse repo) than the rate of interest which banks can earn by lending to people/companies.
- But if banks are parking funds with RBI, banks are sure that they will get their money back.
- If banks have given loans to people/companies, though the bank expects a rate of interest higher than the repo rate, such loans might or might be repaid timely.
- So if the reverse repo rate is sufficiently high, banks will choose to keep parking funds with RBI for assurance of payment.

Day 1



Day 2



Key Differences

Why the Reverse Repo Rate is lower than the Repo Rate?

- The repo rate can be understood as a payment made by commercial banks to RBI, and the reverse repo rate is a payment made by RBI to commercial banks.
- If the reverse repo rate gets higher than the repo rate, the difference between the rates will be the income of the banks.
- This income of the banks due to payments by RBI might not be very large, but the income would be timely and certain.
- So banks might choose to give very less loans to companies/persons and instead park their deposits with RBI only.
- Fewer loans would mean less money supply in the economy, which will reduce the growth of the economy.

BASICS OF THE BANKING SYSTEM IN INDIA (10:00 AM):

Reserve requirements:

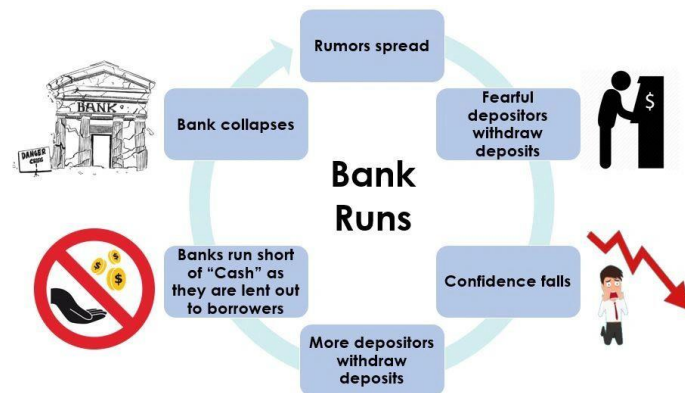
- The primary functions of the banks are to accept deposits and give loans.
- Under situations of a **Bank Run**, there is always a risk with respect to the safety of the depositors.

Bank Run:

It is a situation when the customers of a bank or other financial institution withdraw their deposits at the same time over fears about the bank's financial stability.

All, or even most of them are not going to get their deposit money at that time, because banks have extended their deposit money as loans or parked it with RBI.

As more people withdraw their funds, the probability of default increases, which, in turn, can cause more people to withdraw their deposits.



If one bank collapses, people with deposits in other banks may also face the same fear.

RBI tries to avoid this situation as RBI is also the **Banker of the Banks**.

- As per RBI guidelines, Banks have to maintain some reserves- CRR & SLR.
- This reserve money will not be used by banks for lending.
- The total deposits with the bank include **Demand Deposits**(Current Account, Savings Account) & **Term Deposits**(Fixed Deposit, Recurring Deposit).
- Demand deposits are highly liquid as they can be used by banks at any time.

Net Demand & Time Liabilities (NDTL):

- It is the total deposits of the banks, excluding the **interbank deposits**.
- Interbank deposits are simply those deposits(Demand and Time) that the banks maintain within each other.
- **For example-** SBI opens an account with an ICICI bank, or vice versa.

Cash Reserve Ratio (CRR):

- It is the minimum percentage of the bank's net demand and time liabilities that a scheduled commercial bank is obligated to deposit with the RBI in the form of cash.
- Higher CRR would mean that banks have fewer funds to give out as loans and money supply decreases.
- Banks do not get any interest in the CRR.

STATUTORY LIQUIDITY RATIO (SLR) (10:30 AM):

- The amount of money that banks have to maintain in a liquid form themselves, and not with the RBI.
- Even this money is not used for lending.
- It can be kept in the form of cash, gold, G-Secs, Treasury bills, other securities, etc.
- Higher SLR would mean that banks have fewer funds to give out as loans and money supply decreases.
- Banks can get some interest on the Gsecs that they hold under this.

Government Securities/G-Secs:

- G Sec or government securities can be considered as a bond issued by the government.
- G secs have a maturity period and timely interest payments.
- Through G secs, the government is borrowing money from those who buy the bonds- persons, banks, or companies.

- So G Sec is a manner of debt management of the government done by RBI because RBI issues G Secs on behalf of the government.
- G Secs have with them the promise of timely payments by the government.
- The government will raise resources from any means possible for timely payments of both the interest payments and maturity amount of G Secs.
- This is why G secs are believed to be the safest instrument in the country.
- This is why RBI is so concerned that banks maintain a substantial amount of G Secs with them always.
- G Secs are also very liquid.
- When we refer to Gsecs as liquid instruments, we do not refer to their maturity (they will still mature at their time only).
- But we refer to the fact that Gsecs would be easily sold in the market.
- Simply speaking- someone else will readily give the banks cash in return for G secs.

Fixed Deposit:

- Even a **Fixed Deposit (FD)** is a type of bond through which, banks borrowed money from us for a fixed time.
- But FD is not a **negotiable instrument**, while the G Secs are negotiable instruments.
- This simply means that FD, bonds are promises of future payments, but FDs cannot be sold to someone other than the holder of the FD account.
- Only the FD holder will get the promised amount on maturity.
- While the holder of the G Sec or any bond can sell it to someone else, and the present holder will get interest payments and maturity.

BOND YIELD MOVEMENTS (11: 05 AM):

- Bond returns will generally try to match the bank's interests, or else people will choose fixed deposits over bonds(except government bonds).
- Assume a government bond of 100 rupees with two years maturity, sold at 100 rupees, and gives a fixed coupon of 10 rupees per year till 2 years.
- The **Bond Yield** or the return on the bond every year will be obtained by dividing the **Coupon rate** by the Current price of the bond.
- Coupon rates of the bonds remain fixed, but the bond prices can fluctuate.
- **For example-** if A has a government bond worth 100 rupees, 10-year maturity, 10 rupees coupon, so 10% yield.
- If the government issued another bond later of the same amount, but 11% maturity.
- Now if A wishes to sell his bond to B at 100 rupees, B will not pay 100 rupees for that, because for 100 rupees, B can get the new bond which is paying 11% yield.
- B might be interested in buying the bond if A sells the bond at say 90 rupees.
- Now the yield for B will be $(10/90) * 100 = 11.1 \%$.
- So as bond price decreased (100 to 90), bond yield increased(10% to 11.1%)
- If the economic situation has worsened, and people are seeking government bonds for security, B might even pay Rs 110 for A's bond(purchased at 100, 10 rupees coupon).
- In this case, the new yield of B will be $(10/110) * 100 = 9.9\%$
- So as the bond price increased(100 to 110), the bond yield decreased (10% to 9.9 %)
- We see that there is an inverse relationship between the bond yield and the bond price.

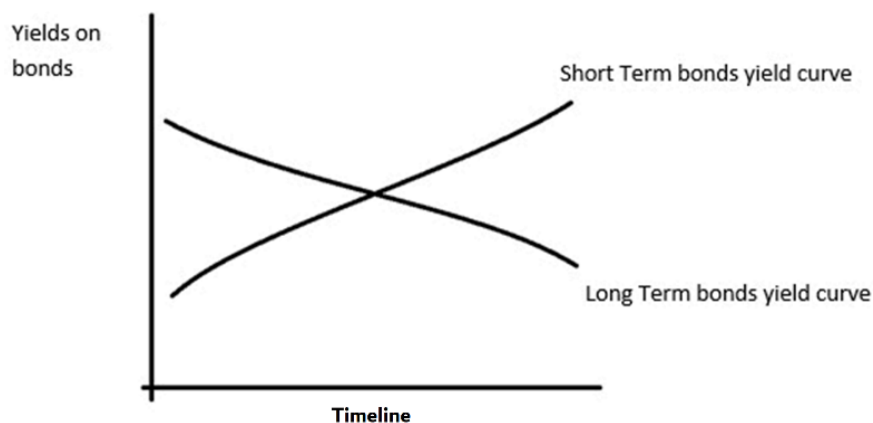
Open Market Operations(OMOs):

- The OMOs include the purchase or sale of government securities for injection or absorption of liquidity in the market.
- Quantitative Easing was an OMO for injecting liquidity.

- If RBI wishes to increase growth/GDP, RBI will buy G Secs, and push rupees in return in the market.
- If RBI wishes to control inflation, it will sell G Secs and reduce the rupees from the market.

Operation Twist:

- The rationale behind the operation twist is to stimulate the economy by lowering the long-term interest rates.
- This is achieved by selling near-term securities(bonds) to buy longer-dated ones.
- Purchasing long-term government securities to drive their prices up, thereby bringing their yield down.
- At the same time, it sells short-term securities of equal amounts to push their yield up.
- As a result of the combination of these two actions, the yield curve is twisted.



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- The point of intersection is where the RBI started operation twist.
- Both the operations- buying long-term bonds and selling short-term bonds of equal amounts are important to not increase inflation due to increased money supply.
- Bond prices are inversely related to the bond yield.

The topics for the next class are the continuation of bonds and qualitative tools of RBI.