Economics Class 10

28th July, 2023 at 9:00 AM

REVISION OF THE PREVIOUS CLASS (9:00 AM):

- **Benchmark Prime Lending Rate(BPLR)** was used as a benchmark rate for lending till June 2010.
- Under BPLR, bank loans were priced based on the actual costs of funds.
- Under this system, banks subsidized corporate loans by charging higher interest rates to retail customers and small enterprises.
- The BPLR system was replaced by the **Base rate system** because of its lack of transparency.
- The base rate was the minimum rate at which loans could be given out, except for some exceptions like agriculture.
- The Marginal Cost of Lending Rate (MCLR) was the minimum rate below which banks should not give loans.
- RBI aims to have a system where any change in repo or reverse repo rates will be reflected in the lending rates that the banks use.

Risk-Weighted Assets (RWA):

- From the bank's perspective, the loans extended are assets, as the loans will be repaid along with interest.
- Banks don't give loans to everyone at the same rate of interest.
- Banks classify the loans they gave as per the risks associated with repayment.
- Credit card loans are very risky, while loans that are backed by some mortgage are considered to be safe.
- The risk-weighted assets of the banks might be more or less than the total loans they had extended, as per the nature of the loans.

DEBT INSTRUMENTS OF THE GOVERNMENTS (9:30 AM):

Treasury Bills (T-Bills):

- They are the money market instruments issued by the RBI on behalf of the central government.
- T bills are also called discounted securities, as they are issued at a discounted rate over the face value, and purchased at the face value.
- **For example-** a treasury bill with a face value of 100 rupees is issued at a discounted rate of 80 rupees and purchased at the original face value (100) at maturity.
- The return or yield on this T bill is equal to ((100-80)/80)*100 = 25 %.
- They are also called zero-coupon or non-coupon bonds, as they do not offer regular interest.
- Treasury bills are issued by RBI on behalf of the central government only.
- Government securities are issued by RBI on behalf of both central and state governments.

Dated Securities:

- These are long-term securities or coupon bonds with a general maturity period of more than one year.

External benchmarks:

- To ensure complete transparency, RBI mandated banks to adopt a uniform benchmark within a loan category starting from October 1st, 2019.
- They are different from MCLR which was an internal benchmark(fixed by the banks themselves).
- RBI has offered banks options to choose from four external benchmarks:
- I. RBI repo rate.
- II. 91-day treasury bill yield.
- III. 182-day treasury bill yield.
- IV. Any other benchmark market interest rate as developed by the Financial Benchmark India Private Limited.

Benefits of external benchmarks:

- Banks are free to decide their **spread** and above their external benchmark.
- **Bank Spread** is the difference between the interest on the loans given by the bank and the interest on deposits they hold.
- Bank Spread can be understood as the major profit of the banks.
- However, the interest rates must be changed as per the external benchmark at least once every three months.
- The adoption of external benchmarks will make interest rates transparent.
- being an external system, any policy rate cut will reach the borrower faster.
- The borrower will also know the spread or profit margin for each bank over the fixed interest rate.
- This will make loan comparison easier and more transparent.

MARGINAL STANDING FACILITY (MSF) (10:00 AM):

- Banks can use this facility to borrow overnight funds from RBI
- It was introduced by RBI in May 2011.
- Banks have to exchange securities with RBI to avail of overnight credit through MSF.
- SLR securities can be used for this.
- The maximum credit a bank can avail of through MSF is 3% of its Net Demand & Time Liabilities (NDTL)
- The difference between MSF and Repo rate is the spread or the liquidity gap between borrowing and lending of RBI.

Standing Deposit Facility(SDF):

- It is the instrument to reduce liquidity from the market without the use of G Secs.
- It is the rate at which banks park their money with RBI without RBI pledging G Secs.
- Reverse Repo Rate transactions needed underlying G Secs.
- SDF is used for liquidity adjustments, instead of fixed reverse repo rates.
- Higher SDF would make banks deposit more money to RBI, leaving less money to be given in loans.

Bank Rate:

- It is the rate at which RBI lends to banks and other financial institutions for the long term.
- Currently, bank rates are not used for policymaking, rather they are called **penal rates.**

INFLATION TARGETING REGIME BY RBI (10:30 AM):

- Too much focus on keeping inflation low could make RBI keep interest rates higher.
- This can increase the cost of taking loans.
- This will decrease loans available for corporates for expansion and job creation.
- Also, people will purchase high-value goods like cars, houses, etc.
- Hence, too much focus on keeping inflation low would reduce GDP growth.
- We have read this under the **Monetary Policy Dilemma.**

Issues with Inflation Targeting:

- RBI wishes to control inflation(Consumer Price Index-Combined-CPI-C), but RBI has very less control over CPI.
- Inflation spikes due to sudden supply-demand mismatches for commodities like fruits, vegetables, petroleum, etc.
- Agricultural prices depend largely upon monsoons and seasons.
- Crude oil prices are dependent upon external factors.
- RBI has no control over them.
- RBI only has control over demand-pull inflation(rising demand through more income or loans) and not over cost-push inflation (rising production prices).

- Even within its domain, RBI faces problems in the proper transmission of monetary policy.
- Inflation needs to be controlled by both the monetary policy of RBI and the fiscal policy of the government(taxes, subsidies, etc).
- RBI would have had much larger control over inflation if every transaction(big or small) happened through bank loans.
- Also, a good portion of the economy runs outside formal or institutional channels, which function outside the supervision or functioning of RBI.
- That would see the effect of changes in the repo rate or reverse repo rate in all transactions.

QUALITATIVE TOOLS (11:00 AM):

- They are the tools of **selective credit control.**
- They focus on discriminating between essential and non-essential sectors.
- The **Banking Regulation Act 1949** has given extensive powers to RBI to apply the tools
- These tools can be targeted over specific sectors, unlike the quantitative tools which target the whole economy.

Margin requirements:

- It was introduced in 1956.
- The term"margin" denotes that part of the amount which cannot be borrowed from banks.
- This portion has to be arranged by the borrower himself.
- RBI has the power to vary margin requirements depending on business conditions.
- During the inflationary period, RBI will raise the margin, and RBI decreases the margin during the deflationary period.
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	Price of house	**Loan Available**	**Money to be paid by us**
Case 1	1 crore	60 lakhs	40 lakhs
Case 2	1 crore	40 lakhs	60 lakhs

- In the second case, there will be less demand for house loans.
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Deflationrefers to a fall in prices.
Disinflation refers to the fall in the inflation rate.

Consumer Credit Mechanism:

- Under this method, consumer credit and supply are regulated through down payments, installment amounts, and also loan duration.
- **For example-** during covid, RBI declared a moratorium on repaying loans.
- It simply means extending the period of loan repayment to give relief to people.
- But this step could also be used for increasing demand in the economy.

Loan To Value (LTV) ratio:

- It is the proportion of the property value that a lender can finance through a loan.
- For example, if there is a 50% LTV ratio for gold loans, anyone can get at max 50 lakhs loan on pledging gold worth 1 crore.

RATIONING OF CREDIT (11:30 AM):

- Credit is rationed by limiting the amount available for each commercial bank.
- This method controls the **rediscounting of bills** by RBI.
- there is an upper limit of credit that is fixed by RBI and banks are asked to follow the limit set by RBI.
- If the banks fail to follow the limit, RBI can go to the extent of stopping rediscounting of bills.

Rediscounting :

- Under discounting, a company will sell its invoice (to be paid) to another financier (a bank or financial institution) which will pay the outstanding amount at a due date.
- This is used if the buyer will pay after some time, but the seller needs immediate payment.
- A negotiable bill may be generated as per the invoice of the goods sold.
- This can work as a mechanism for short-term borrowing.
- **Rediscounting** the bills will happen if some other entity (bank or financial institution) buys the bill before its due date.

Credit Authorization Scheme (Not in existence now):

- This was introduced in 1965 as a selective credit control tool.
- Under this, commercial banks were asked to obtain prior approval from the RBI for giving any fresh credit of rupees 1 crore or more to any single party.
- However, the scheme was discontinued in 1982.
- The idea behind the scheme was to watch the flow of credit to the borrowers closely.
- And also ensure that commercial banks are lending loans as per their credit strength and the actual requirement of borrowers.
- Even now, RBI monitors certain bank credits above 5 crores to any single party(Credit Monitoring Arrangement).

Moral Suasion:

- It is the pressure exerted by RBI on the Indian banking system.
- It is a suggestion to banks and helps in restraining credit during an inflationary period.

Direct Action:

- Under this method, RBI can impose restrictions on a bank if they are not adhering to RBI directives.
- RBI can levy penal rates, and at times go to the extent of canceling licenses.

Self Study:

Students can go for Sanjeev Verma's book over Ramesh Singh's.

The second module of the 5 Economics modules of printed material must be read compulsorily.

Students must only write the answers as provided in the class.

Beyond that, students must focus on reading (not memorizing) answers to previously asked questions.

We need to take note of the keywords, and not make notes from that.

We can also read questions on the topics that have not been covered in class.

Students must aim for at least above-average performances in all General Studies papers.

We will also have some GS papers/Essays/Optional papers which can fetch us very good marks.

This average game also works for each individual paper.

So we need to focus more on attempting all the 20 questions of at least above average level.

We observe certain candidates keep clearing stages of the exam again and again.

This is mainly due to confidence and the target of attempting the Mains Examination(Not mocks) as soon as possible.

The first attempt and the first 6 months of preparations are going to be very crucial.

The topics for the next class are Investment models and economic planning