Economics Class 09

27th July, 2023 at 9:00 AM

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

- **Open Market Operations (OMOs)** include the purchase or sale of government securities for injection or absorption of liquidity in the market.
- 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.
- 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.
- **The dual Dilemma** is the dilemma concerning the focus of monetary policy- whether to focus on growth or inflation.
- Dual dilemmas are generally faced when there is low growth and high inflation.
- Inflation can be controlled by increasing the borrowing interest rates which would reduce the money supply (as explained later with the Repo rate).
- But higher interest rate makes both individuals and businesses hesitant to take loans for demand and expansion.
- This results in lower economic growth.

MONETARY POLICY AGREEMENT IN INDIA (9:30 AM):

- In 2015, the central government and RBI signed a monetary policy framework agreement.
- The new monetary policy framework was formed based on the recommendations of the **Urjit Patel Committee.**
- The objective of the monetary policy framework is to primarily maintain price stability(inflation), along with tracking the economic growth of the country.
- As per the agreement, RBI would set policy rates to maintain inflation within a prescribed limit of 4 + or - 2 % CPI.
- So the permissible range was 2-6 % inflation.
- RBI will be deemed to have missed its target, if consumer inflation is more than 6% or less than 2% for 3 consecutive quarters, starting from 2015-16.
- RBI has to submit a report mentioning reasons and remedial recommendations.

Monetary Policy Committee (MPC):

- It will replace the earlier framework under which the RBI governor had complete control over the monetary policy decisions.
- While a **Technical Advisory Committee** advises RBI on monetary policy decisions, the central bank is under no obligation to accept its recommendations.
- The MPC will have six members with three appointed by RBI and the remaining three nominated by an external selection committee.
- The RBI governor will also have a casting vote in case of a tie.
- As per the Finance Bill 2016, the committee will consist of:
- I. RBI Governor
- II. Deputy Governor
- III. One official nominated by the RBI.
- The other three members will be appointed by the central government through a search committee.

- This committee will consist of:
- I. Cabinet Secretary.
- II. Secretary of the Department of Economic Affairs.
- III. RBI governor.
- IV. Three experts in the field of economics and banking as nominated by the central government.

MONETARY TRANSMISSION (9:55 AM):

- It refers to the process by which a central bank's monetary policy decisions are passed on through the financial markets, and later to businesses and households.
- It is nothing but the idea that the repo rate change should get reflected in the bank's interest rate policy.
- In 1994, RBI announced the landmark decision to fully deregulate interest rates on loans above two lakhs.
- Since then, RBI introduced four benchmark lending rates for proper pricing and transmission of loans.

Problems for the banks:

- Between 2011-2016, banks faced profitability issues concerning the loans they extended.
- Infrastructure loans are of large amounts and are extended with long repayment periods.
- Banks use short-term deposits to fund long-term loans.
- In cases of losses, delays in repayment, or Non-Performing Assets, banks faced asset-liability mismatch.
- Banks cannot lend some portion of their funds which were to be kept under reserve requirements- CRR & SLR.

Twin Balance Sheet problem:

- Due to the poor performance of the corporates that took loans from the banks, corporates faced losses in their balance sheets.
- Due to the non-repayment of loans even the balance sheets of the banks showed losses.
- As a result, banks sought to increase the interest rates on the other loans they extended, to cover their profit margin.
- Higher interest rates meant costlier loans and slowed down growth.

Double Financial Repression:

- Banks pointed out that they were being repressed both at their assets and liabilities sides.
- Banks' capacity to give out **loans(assets for the banks)** was restricted due to the reserve requirements and norms for **Priority Sector Lending (PSL).**
- PSL loans are given to specific areas (farming, education, MSME, etc.) at lesser rates of interest.
- Banks have to give 40% of their total loans to the priority sectors.
- Financial repression on the **liability (deposits held by the banks)** side was due to some government schemes that gave higher rates of interest than the bank's interests.
- This liability side repression can also be faced due to high inflation.
- Higher inflation discourages deposits in banks as the real rate of interest is low or negative.
- This is because banks provide only **nominal interests.**
- The **real interests** will be after we will consider the effect of inflation.
- **For example,** if we get a 7 % savings rate in banks and the inflation is at 5%, our savings will be at 2% (7-5%).
- Usually, banks' deposits rate are around 4% and inflation is around 1-2 % higher than that.
- So in reality, the value of our savings is decreasing while in banks.
- To get real benefits, people park will their funds at other places like gold, share markets, etc.
- Due to the problems which banks faced, banks did not reduce their lending interest rates, even if RBI reduced repo rates.

INTERNAL BENCHMARK LENDING RATE (IBLR)(10:30 AM):

- It is a set of lending rates that are calculated after considering factors like:
- I. Bank's current financial situation.
- II. Deposit rates.
- III. NPAs, etc.
- Benchmark Prime Lending Rate (BPLR), Base Rate, Marginal Cost of Funds Lending Rate (MCLR), etc. are all internal benchmark rates.
- These rates are called internal rates because banks or financial institutions decide these rates on their own.

Benchmark Prime Lending Rate(BPLR):

- It was used as a benchmark rate for lending till June 2010.
- Under BPLR, bank loans were priced based on the actual costs of funds.
- However, BPLR resulted in an opaque system.
- The bulk of wholesale credit (loans to corporates) was given at a sub-BPLR rate, and it comprised nearly 70% of all bank credit.
- Under this system, banks were subsidizing corporate loans by charging higher interest rates to retail customers and small enterprises.
- Banks wished to give more loans to big corporates because banks hoped that the big corporates would pay for other services of the banks too.
- So to give cheaper loans to big corporates, and maintain their profit margins, banks charged higher rates from normal retail customers.

BASE RATE (11:10 AM):

- The BPLR system was replaced by the Base rate system because of its lack of transparency.
- Loans taken between June 2010 and April 2016 were based on the base rate system.
- The base rate was the minimum rate at which loans can be given out, except for some exceptions like agriculture.
- This base rate was also an internal benchmark (set by the banks) which was decided on certain factors:
- I. (Average) Cost of funds.
- II. Operating expenses.
- III. Cost incurred on maintaining CRR (as no interest on CRR).
- IV. Profitability.
- The cost of funds here refers to the cost which banks incur to raise funds that can be used for giving out loans and other purposes.
- Banks raise funds from many sources- RI, loans (fixed deposits, bonds, etc.), share markets, etc.

The base rate system did not lead to monetary transmission due to reasons like:

- The base rate was not changed every month,
- The repo rate was not directly reflected in the formula for calculating the base rate.
- Between 2011 and 2016, banks were facing problems like high NPAs, Double Financial Repression, etc.
- Federal Bank USA policies- which make US dollars stronger and the rupee cheaper.
- Challenges of infrastructure loans, etc.
- If the USA Federal Reserve increases interest rates, bond yields will increase.
- That will make investors take out their capital from India and other markets and shift them to the USA market to get better returns.

MARGINAL COST OF LENDING RATE (MCLR) (11:40 AM):

- It is the minimum rate below which banks should not give loans.
- MCLR superseded the previous base rate system in determining the commercial banks' lending rates.
- The rate was calculated as per parameters like:
- I. Marginal Costs of Funds.
- II. Carrying costs of CRR.
- III. Tenor premium.
- Tenor refers to the expected time of repayment of loans.
- For long-term loans, banks include a certain premium because longer repayment terms mean more risks of default/delay.
- Banks associate different risk assessments with respect to the different kinds of loans that they give.
- Personal loans have higher risks associated with their repayment because they are mainly not secured by any mortgage/guarantee.
- So banks will charge higher interest for these loans.
- Similarly, the loans which are backed by guarantees see lower interest rates.

Marginal costs of funds:

- It is the additional or increased costs incurred by the banks for arranging new funds.

Reasons for introducing MCLR:

- Ensuring monetary transmission.
- Increasing transparency in the bank interest rates calculation.
- To make bank lending available at rates that are fair to both lenders and borrowers.
- To assist banks in becoming more efficient and profitable in the long run as well as contribute to economic development.
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Material for self-study:
Indian Economic Development class 11
NCERT.

The topic for the next class is the continuation of the monetary policy.