GS FOUNDATION FOR CSE 2024
ECONOMY-6
MONEY, MONEY SUPPLY, MONETARY AGGREGATES, RBI, MONETARY POLICY

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2. MONEY

1) MEANING AND EVOLUTION:

- A thing which is commonly accepted as **medium of exchange** is called Money.
  - E.g.
    - A rupee in India is money. In older times coins of gold and silver were considered money.
- Other than acting as medium of exchange, **money has following uses**:
  - Store of value (instrument of saving)
  - Measure of value
  - Standard of deferred payments (payments made sometimes in future)
- So, **more comprehensively**, money can be defined as an instrument that serves as medium of exchange, store of value, measure of value and standard for deferred payments.

2) BARTER SYSTEM OF EXCHANGE:

- It is a system in which goods are exchanged for goods.
- **Drawbacks:**
  - **Requirement of double coincidence of wants**
    - Introduction on money has separated the acts of sale and purchase.
  - Lack of common unit of value
  - Difficulty of future payment and contractual payment
  - Difficulty of storage of value and transfer of value
- Money has taken care of all these drawbacks.

3) FORMS OF MONEY:

i. **Fiat Money and Fiduciary Money**

- **Fiat money** is that money which is issued by order/authority of the government. It includes all notes and coins which the people in the country are **legally bound to accept** as a medium of exchange.
  - **Understanding Legal Tender and Fiat Money**
    - **Fiat money** doesn't have an intrinsic value. What value it has depends on the public confidence in the currency's issuer.

- **Legal Currency** is any currency declared legal by a government. It is legally accepted mode of payment in a country, usually its currency.

» Generally, governments issue a fiat currency and then make it legal tender by setting it as the standard for repaying debt.

» **Fiduciary Money** is that money which is accepted as a medium of exchange because of the trust between the payer and the payee.

- **E.g., Cheques** are fiduciary money as they are accepted as a means of payment on the basis of trust, not on the basis of any order of the government.
- **Note:** Cheques are not legal tender, as they can be refused as a mode of payment by a party.

ii. **Full Bodied Money** and **Credit Money**

- **Full bodied money** refers to money in terms of coins whose **commodity value is equal to the money value** as and when these are issued.
  - E.g., A rupee coin during the British period in India was made of silver. Commodity value of the coin was equal to its money value at the time of its issue.
- **Credit money** refers to that money of which money value is more than commodity value.
  - E.g., money value of a Rs 20 coin today is more than the commodity value of the coin.
    - Otherwise, people would have melted the coins and sold the metal in the market at a price greater than 20 rupees.
- **In Summary:**
  - **In Full bodied money (Money value = Commodity value)**
  - In **Credit Money** (Money value > Commodity value)

3. MONETARY AGGREGATES

- **Money Stock/Money Supply**: Money stock or money supply refers to the total amount of money available in the economy at a particular point of time. It is also called Money Supply.
  - It is important to measure money supply as it plays important role in an economy.

- **How is money supply measured in India?**
  - Reserve bank of India, over the years have used various methods of measuring money supply. The **current method followed by RBI** is based on the recommendations of '**Working Group on Money Supply: Analytics and Methodology of Compilation)** which was formed in **1997** under the chairmanship of **Dr. Y. V. Reddy**. This working group considered the changing circumstances of Liberalization, Privatization and Globalization (LPG) and suggested changes to ensure that the Indian standards are close to international standards.

  - **Sectorization of the Economy** (for the purpose of monetary and liquidity aggregates)

- The third working group on Money supply (chaired by Y.V. Reddy) has divided the economy into the **domestic sector** and the **rest of the world**.
- The **domestic sector** is further divided into **four exclusive sectors**: viz.,
  i. Households
  ii. Non-Financial Commercial Sector
  iii. General Government
  iv. Financial Corporations (It comprises of the banking sector, consisting of the RBI and the banking systems in India and the other financial corporation sector). The other financial corporation sector comprises development financial institutions such as term lending institutions, refinancing insurance corporations, mutual funds and NBFCs accepting deposits from the public.
- The **domestic sector** can also be classified as money issuing sector and money holding sector.
  i. Money issuing sector comprises of RBI and Banking systems in India.
  ii. Money Holding Sector comprises households, other financial corporations, and non-financial commercial sectors.

- **Monetary and Liquidity Aggregates:**
  - The third working group on monetary supply recommended **two different financial aggregates** namely, monetary aggregates and liquidity aggregates.

  - The working groups observes: "The partition between **monetary and liquidity aggregates** has been dictated by the fact while the first relates only to monetary liabilities of the Central Bank and **depository corporations**', i.e., the banking system, the latter also includes select items of financial liabilities of **non-depository corporations** such as development financial companies, and non-banking financial companies accepting deposits from the pubic apart from post office savings.
    i. **Note:** The Development finance institutions which don't accept time deposits from public are called **non-depository corporations.**
    ii. **Note:** Liquidity aggregates include a greater number of financial assets than those included in the Monetary aggregates.

- **Monetary Aggregates:** The new monetary aggregates (money supply) are of four types. They are:
  i. Reserve money or Base Money (M_0)
  ii. Narrow Money (M_1)
  iii. Intermediate Money (M_2)
  iv. Broad Money (M_3)
  v. **Note: Till 1997**, RBI followed the older method which included M1, M2, M3 and M4.

A) M_0 (RESERVE MONEY OR BASE MONEY OR HIGH-POWERED MONEY): CURRENCY IN CIRCULATION [BANK + PUBLIC] + BANKERS DEPOSIT WITH RBI

M0 (Reserve Money or **High-Powered Money**): Currency in Circulation (currency with Bank and Currency with Public) **+** Bankers' deposit to RBI.

Currency in circulation = Currency with Public + Currency in deposits of Banks

M0 is also known as the **base money** as it would set the base of the economy. It is **roughly equal to total liability of the RBI** (how many notes have been printed by RBI)

B) MONEY SUPPLY: NARROW MONEY (M1) = C + DD + OD

- **Where do people keep money when they don't invest** (i.e., where do people keep liquid money)
  - **C: Currency with public**
  - **DD: Net Demand deposits in Bank** (Saving Account + Current Account)
    - Note1: We don't use time deposits (fixed deposits) here as they are not perfectly liquid.
    - Note2: **Understanding Net Demand Deposits**
      - **Gross Demand Deposits** include inter-banking claims i.e., claims of one bank against the other. **Net Demand Deposits** don't include inter-banking claims. Inter-banking claims are not a part of demand deposits of people.
  - **OD:** Other Deposits with RBI. It includes:
    - **Demand deposits** with RBI of public financial institutions like NABARD
    - Demand deposits with RBI of foreign central banks and of the foreign governments
    - Demand deposits of International financial institutions like IMF and World Bank
  - **Note:** M1 doesn't include:
    - Deposits of the government with the RBI
    - Deposits of the country's banking system with the RBI
  - **Why are cash deposits of the government and of the commercial banks with the RBI not treated as a part of the money supply?**

- Because government and commercial banks are <u>creators/suppliers</u> of money. And money held by the <u>creators/suppliers</u> of money is never treated as a part of money supply.

- **Understanding the relation between reserve ratio and money supply:**
    - Person 1 has 100 rupees. He deposits this in ICICI Bank.
    - If CRR Is 100%, then M1 = 100
    - But if CRR is 10%, Bank will lend this money, 90 rupees to someone (money with public), which in turn may become deposit in another bank (let's say HDFC). This cycle would continue.
    - Here M1 = Deposit with ICICI + Deposit with HDFC + Deposit with third bank + and so on…
    - So, if Reserve ratio reduces -> M1 increases (i.e., **higher the reserve ratio, lower the money supply**)
    - **In a functional economy, money supply is always greater than 1**.

- **Money multiplier** = Stock of Total Money / Stock of High-powered Money (M0)

C) M2 (INTERMEDIATE MONEY):

- This is called intermediate money because <u>financial assets included in this category are more than those included in M1 but less than those included in M3</u>.
    - **M2 =** M1 + **<u>Time Liabilities portion</u>** of the saving deposits with the Banking System + Certificates of Deposits issued with Banks + Term Deposits (excluding Foreign Currency Non-Resident (Bank) (FCNR(B)) Deposits) upto one year maturity with banking system.
    - It can be rewritten us:

        = **Currency with the public** + Current Deposits with the Banking System + Saving Deposits with the Banking System + Certificate of Deposits issued by Banks + Term Deposits (excluding FCNR(B). Deposits) upto and including one year maturity with the banking system + other deposits with the RBI.

D) M3 (BROAD MONEY):

- The financial assets included in this category are <u>more than those included in the category of M2</u>. Thus, it defines money in a wider sense. So, it is called <u>Broad Money</u>.
- **M3 =** M2 + Term Deposits (excluding FCNR (B) deposits) over one year maturity with the Banking System + call borrowings from 'Non-Depository' Financial corporations by the banking system.

Older Methods	**M1: Narrow Money:** Currency with public + Demand Deposits of Banks + Other Demand Deposits with RBI

	M2: Intermediate Money: M1 + Post office's demand deposit (only savings) **M3: Broad Money:** M1 + net time deposits (fixed deposits) with commercial banks ▪ If money supply in the country is measured using M3 measure, it is called '**aggregate monetary resources'** of the country. **M4: Broad Money:** M3 + Post Office deposits (both demand and time) [other than in the form of National Saving certificates]

- **'Narrow Money' and 'Broad Money**' concept of money supply:
    - <u>If M1 or M2 measure are used for estimating total money supply in the country</u>, it is known as '**narrow money**' concept of money supply.
    - <u>If M3 or M4 measures are used</u> for estimating total money supply in the country, it is known as **'broad money**' concept of money supply.

- **The Concept of Liquidity:**
    - Liquidity of an asset refers to its <u>convertibility into money/cash</u>. Faster an asset can be converted into cash, <u>**more liquid**</u> it is.
        - **Chequeable deposits/ demand deposits** are <u>highly liquid assets</u>. We can state that <u>**M1** includes **only those components** of money supply which are most liquid</u>.

        - **Time deposits or time deposits/ fixed deposits** are <u>not chequeable deposits</u>. These can't be withdrawn by issuing a cheque. These deposits are, therefore, <u>less liquid than the demand deposit</u>.
            - Accordingly, <u>**M3 and M4** measures of money supply</u> includes such components of money supply which are <u>less liquid</u>.

- **Liquidity:** M1 > M2 > M3 > M4

- **Money Multiplier (M_b) = M_3/M_0**
    - M3 = $M_0 * M_b$
    - So, if M_b is equal to 5, in this case M0 will be multiplied by 5 to achieve broad money.
        - It means, <u>money supply will increase five times</u>.
    - Money multiplier is thus telling how the <u>base money multiplies in the banking system of the economy</u>.
        - Banks create new money whenever they create loans. When Money multiplier is higher, it indicates the banking system is able to create higher money supply out of money given by central bank.

- **Liquidity Aggregates:**
  - **L_1 =** M3 + All deposits of post office saving banks excluding National Savings Certificates (NSCs)
  - L2 = L1 + Term Deposits with Term Lending Institutions and Refinancing institutions (FIs) + Term borrowing by Refinancing Institutions + Certificate of Deposits issued by FIs.
  - L_3 = L2 + Public Deposit of Non-Banking Finance Companies (NFBCs)

4. MONEY SUPPLY MEASURES REPORTED IN ESI 2022-23

Item
1. Reserve Money (M0)
1.a. Currency in Circulation (CiC)
1.b. Bankers' Deposits with the RBI
2. Narrow Money (M1)
3. Broad Money (M3)
3.a. Currency with the Public
3.b. Aggregate Deposits
Demand Deposits
Time Deposits

– **Reserve Money (M0): Currency in Circulation (CiC) + Bankers' deposit with RBI**. Reserve Money has increased 10.3% as of Dec 2022 compared to 13% last year. So far, increase in M0 was mainly driven by **Banker's deposit with RBI**, with an increase in CRR. **CiC** has broadly remained stable.

– **Broad Money (M3)**: increased by 8.7% YoY as of Dec 2022. From Component side, Aggregate deposit has been the largest component and contributed most to the expansion of M3 during FY23. Among sources, **Bank Credit** to the commercial sector drove the expansion of broad money and the net bank credit to government supplemented the expansion.

– **Share of Bank Credit to commercial sector** in M3 increased to 64.3% as on 30th Dec 2022 from 61.1% in the corresponding period of the previous year, reflecting the upswing in the credit disbursal by commercial banks.

5. RESERVE BANK OF INDIA

- It is India's central bank which was set up in 1935 under the **RBI Act, 1934**.
- **Other facts about RBI:**
    - Initially, RBI also had private ownership, but **in 1949 it was nationalized**.
- **Administration**
    - The **Board of Directors** (21 members) is the key decision-making body of RBI. It consists of:
        i. RBI Governor
        ii. Four Deputy Governors
        iii. Two Finance Ministry Representatives (usually Economic Affairs Secretary and the Financial Services Secretary)
        iv. Ten government nominated directors to represent important elements of India's economy.
        v. Four directors to represent local boards headquartered at Bombay, Calcutta, Madras and New Delhi.

6. FUNCTIONS OF RBI

RBI is a "**Full Service Central Bank"** and is responsible for:

1) MONETARY FUNCTIONS:

These are the functions concerned with money like issue of money, quantity of money, control of money supply etc.

A) ISSUE OF CURRENCY (RBI IS THE BANK OF ISSUE)

- All currency in India (except Rupee 1 notes and Coins of all denominations) are issued and circulated by RBI.
    - **Note:** Rupee 1 note and All coins are issued by Ministry of Finance, GoI, but is circulated, distributed and handled by RBI.
- Currencies are issued by the RBI with the **backing of reserves** comprised of gold and foreign exchange. This is **Minimum Reserve System** which has been followed from 1956 onwards.
    - Under this system, RBI has to keep a minimum reserve of Rs 200 crore comprising of Gold and foreign exchange.
        » **Rs 115 crore should be in gold and Rs 85 crore in foreign securities.**
- **Note:** This minimum reserve is a token of confidence and doesn't have any practical implication for the amount of currency that can be printed. Unlimited amount of currency can be printed by keeping this reserve of 200 crore.
- Money supply expansion is decided on the basis of economic growth. Higher the economic growth, higher will be the newly issued money by RBI

B) BANKER AND DEBT MANAGER TO GOVERNMENT (CENTRAL GOVERNMENT AND STATE GOVERNMENTS (EXCEPT SIKKIM))

- RBI maintains bank account for government, receive payments into and makes payment out of it.
- It also helps the GoI to raise money form public via issue of bonds and government securities.
- In **Sep 2019**, RBI decided to align its financial year (July-June) to April-March to get in sync with the central government.
- **Note:** For Sikkim, State Bank of India is the banker.

C) BANKER'S BANK

- It is the central bank where commercial banks are account holders and can deposit money. It maintains a banking account of all scheduled Banks.
- Further, it provides financial assistance to banks against mortgaged securities. It rediscounts the bills of exchange.
- RBI is thus a lender of last resort.

D) MANAGEMENT OF FOREIGN EXCHANGE (WILL COVER IN DETAILS WITH EXTERNAL SECTOR)

E) CONTROLLER OF MONEY IN THE MARKET (CREDIT)

F) KEEPS INFLATION IN CHECK.

- It does it through regulating money supply and credit in the country.
- It is thus responsible for India's Monetary Policy (now being taken care of by **Monetary Policy Committee**)

2) REGULATE BANKING SECTOR (COMMERCIAL BANKS, NBFCS ETC.)

3) REGULATE AND SUPERVISE PAYMENT AND SETTLEMENT SYSTEM.

- The Payment and Settlement System Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country.
- Here RBI focuses on payments systems like IMPS, NEFT and RTGS.

4) IT ALSO PLAYS AN IMPORTANT ROLE IN DEVELOPMENTAL STRATEGY OF THE GOI.

7. RBI'S FUNCTION AS CONTROLLER OF MARKET CREDIT (IN DETAILS)

- The method of credit control is of two types - **Quantitative Method and Qualitative Method**. Both these methods can further be divided into conventional and non-conventional measures.
    - **Conventional measures** are those which are being used for a long time. Non-Conventional measures are those which have been introduced recently, say after 1990s.

- **Quantitative Methods:** These are aimed at controlling the cost and quantity of credit. It doesn't discriminate between different sectors and end use of the credit. These are applicable to whole economy.

1) CONVENTIONAL QUANTITATIVE METHODS INCLUDE BANK RATE, OPEN MARKET OPERATIONS, AND VARIABLE RESERVE RATIO.

A) BANK RATE POLICY (OR) DISCOUNT RATE POLICY:

- Bank rate or the discount rate is the rate fixed by the Central bank at which it rediscounts first class bills of exchange and government securities held by commercial banks.
- By varying this interest rate, RBI controls the credit. At high Bank rate, money supply will be low and at low bank rate money supply can increase.

B) OPEN MARKET OPERATIONS:

These are market operations conducted by RBI by way of **sale/purchase of government securities, bills and bonds of the government as well as private financial institutions** to/from market with an objective to **adjust rupee liquidity conditions** in the market.

- For instance, in March 2020 due to COVID-19 crisis, more money was required in the market. RBI decided to infuse Rs 10,000 crore liquidity in the banking system by buying securities through Open Market Operations.

C) VARIABLE RESERVE RATIO:

In this method the reserves which schedule banks have to maintain are varied to control the credit creation. There are two types of reserves.

CASH RESERVE RATIO

- **Under RBI Act, 1934** - Scheduled Banks are required to **keep a % of their net time and demand deposits** (i.e., total deposits of customers) in the form of cash (in their vaults) or as deposits with RBI.
- **Objectives of CRR:**

- Since a part of total deposits in bank is available in the form of cash, it can be used to readily make money available to customers when they demand it.
- Further, RBI also controls the amount of money in market and thus inflation through CRR.

- **Note:**
  - Banks don't get any interest for this money deposited with RBI.
  - CRR has to be maintained in cash only.

STATUTORY LIQUIDITY RATIO (SLR)

- **Under Banking Regulation Act, 1949**, Banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold or government securities in their vault itself. It need not be deposited with RBI.
- Banks have to report to RBI every alternate Friday about their SLR maintenance and pay penalties for failing to maintain SLR.
- Interest income is available on SLR (for e.g., when bank earns from investing in government securities)
- **Purpose**
  - Ensure the solvency of the banks by ensuring that banks don't lend all their deposits which would be very risky. Thus, SLR is used to control the bank's leverage for credit expansion.
  - Control the money flow to market.

- **NOTE:** CRR and SLR are to be maintained on daily basis as a % of NDTL on **last Friday of second preceding fortnight**.
- **Penalties** for not maintaining CRR and SLR:
  - Bank Rate + 3% on shortfall
  - Bank Rate + 5% on shortfall on subsequent default days.

2) NON-CONVENTIONAL QUANTITATIVE METHODS:

A) LIQUIDITY ADJUSTMENT FACILITY:

It is a short-term credit control measure. It absorbs the excess liquidity (money supply).

REPO RATE:

Rate at which banks borrow from RBI by mortgaging their dated government securities or treasury bill. This is for short period 2-14 days.

REVERSE REPO

It is the rate at which RBI borrows from commercial banks by mortgaging its dated government securities or treasury bills.

STANDING DEPOSIT FACILITY (SDF)

- In April 2022, MPC decided to institute a new instrument called the SDF as the floor in the Liquidity Adjustment Facility (LAF) corridor.
    - It was recommended by the 'Expert Committee to Revise and Strengthen the Monetary Policy Framework' (Urjit Patel Committee) in Jan 2014.
    - In 2018, the section 17 of the RBI Act was amended to empower the RBI to introduce this instrument.

- With this **fixed rate overnight reverse repo has ceased to be the floor of the LAF corridor**.

- **What happens to Reverse Repo:** It should be noted that reverse repo **continues to remain in the toolkit of the RBI** as a monetary policy instrument and its operation will be at the discretion of the RBI for purposes specified from time to time.

- **SDF, as it stands currently** has the **following features:**
    i. It is floor of the LAF corridor, replacing the hitherto fixed rate reverse repo.
    ii. It is a monetary policy instrument to absorb liquidity without collateral (collaterals in this case are normally government securities).
    iii. It is operated on **overnight basis**, with the flexibility to absorb liquidity for longer tenor with appropriate pricing.
    iv. Deposits under SDF shall not be reckoned as balances eligible for the maintenance of the CRR under section 42 of the RBI Act, 1934, but shall be an eligible asset for maintenance of the SLR under section 24 of the Banking Regulation Act, 1949.
    v. Both the standing facilities - the **MSF** (Marginal Standing Facility) and the **SDF** will be available on all days of the week, throughout the year.

- SDF is designed to **absorb surplus liquidity** which is transient in nature reflected in the increase in deposits of the government with the RBI.
    » This surplus liquidity is primarily on account of an increase in advanced tax receipts, sudden increase in public provident funds and small savings receipts and temporary postponement of certain expenditure.
    » The durable liquidity is in terms of net capital flows either in the form of equity such as FDI or debt such as ECB, NRI deposits and trade credit.

- » SDF being a **non-collateralized instrument gives the flexibility for surplus liquidity management of larger magnitudes as it removes the "binding constraints"** on RBI to possess government securities in its balance sheet.

B) MARGINAL STANDING FACILITY (MSF)

- It is an overnight loan facility given by RBI to banks which have current and Subsidiary General Ledger account with RBI. The interest rate is generally 25 basis points above the repo rate.
- The loans are given against the mortgage of eligible securities, which are government date securities, treasury bills, and state development loans.
  - The loan size can be minimum one crore and further amount is in multiples of one crore.

C) MARKET STABILIZATION SCHEME:

- It is **not a purely monetary instrument**. It is a **fiscal cum monetary instrument**. It is a facility to control liquidity due to excess foreign exchange flow into the country. In this facility, the RBI issues government securities to absorb excess liquidity.
- The interest is paid by Ministry of Finance, GoI. The amount of issue and date of issue is decided by RBI in consultation with Ministry of Finance, GoI.

D) SPECIAL MARKET OPERATIONS:

RBI in recent times is undertaking the following special market operations:

- Operation Twist (OT)
- Long-Term Repo Operations (LTRO)

OPERATION TWIST:

Under this RBI buys Government Securities (GSECS) having long term maturities say five years and ten years and sells GSECS of shorter-term maturities say one year and three year.

- It is one of the methods of **quantitative easing** which is aimed at managing market yield of the bonds mainly to reduce rate of interest in long-term which would help to boost economy.
- Lower long-term interest will infuse money/credit into the economy.
- Higher short term interest rates prevent outflow of investments and foreign exchange.

LONG TERM REPO OPERATIONS:

- **Here,** RBI lends money to the banks for one to three years by accepting GSECS as collateral. It is lent at repo rate. It helps in infusing liquidity in the market at lower rate of interest.

3) QUALITATIVE (OR) SELECTIVE METHODS:

These methods control the use and direction of credit. These discriminate between sectors. Currently, RBI is not using most of these methods. It primarily uses the qualitative control method.

A) REGULATION OF MARGIN REQUIREMENTS:

Margin is the amount that has to be contributed by a borrower towards the purpose for which she/he borrows.

B) REGULATION OF CONSUMER CREDIT:

- Two devices are used here:
  - **Minimum Down Payment**
  - **Period of Repayment**

C) RATIONING OF CREDIT:

Here maximum about of credit flow to a particular sector is controlled. There are two methods:

- **Variable Portfolio Ceiling**
  - Under this the maximum amount of credit for various portfolios (various sectors) is fixed. Different ceilings for different sectors is fixed.
- **Variable Capital Risk Weighted Asset Ratio**
  - Capital to Risk Weighted Asset Ratio (CRAR) is also called Capital Adequacy Ratio (CAR). It signifies the availability of sufficient capital as a percentage of risk weighted assets.

D) DIRECT ACTION:

Central bank issues certain policy decisions from time to time on the prevailing situations in the economy.

E) MORAL SUASION

Methods of persuasion, methods of request, methods of informal suggestion and methods of advices to commercial banks, about dos and don'ts by calling a meeting.

F) PUBLICITY:

It denotes the publication of weekly or monthly statements of assets and liabilities of commercial banks. This brings transparency and puts moral pressure on erring banks not to violate norms. So, banks abide by credit control measures.

8. RBI AND INFLATION TARGETING

- **Introduction**
  - The Monetary policy is generally focused on **regulating supply of money in an economy** by the monetary authority of the country for achieving **GDP growth**, **stable business cycle, price**

stability, and **exchange rate stability.** Like fiscal policy, it is an integral arm of public policy. It **cools down the economy** when it overheats (through contractionary monetary policy) and **boosts the economy** during depressed financial activity (through expansionary policy).

- **Expansionary** monetary policy is achieved by lowering Repo Rate, Reverse Repo Rate, CRR, SLR etc. i.e. by **increasing the availability of money in the economy**.

– **India's Current Monetary Policy**

» **In the past**, RBI had pursued a **multiple indicator approach** i.e. it tried to control multiple outcomes - inflation, growth, exchange rate, and even balance of payment - through monetary policy.

» But **RBI Act, 1934** was **amended in 2016** to introduce the framework of **Flexible Inflation Targeting** (FIT).

- Under FIT, the primary objective of the Monetary Policy is to **ensure price stability** (i.e. ensure inflation in a particular range). Inflation is measured in terms of **Consumer Price Index (CPI),** thus making monetary policy contributes to **welfare of people**.
  - Further, it also **promotes transparency** as lay person can easily judge if the monetary policy is working for the betterment of the people of India.
- The amendment provides that **inflation target** would be set by Central government, after discussing with the Reserve Bank, **once in every five years**.
  - **For 2016-2021,** the central government had set a target of 4% inflation rate with a **tolerance of +-2%**. Again for 2021-26, the centre has decided to **retain the inflation target of 4%, with a tolerance band of +/- 2 percentage** points for the MPC of RBI.
    - This tolerance band has been provided to deal with supply shocks like vagaries of Monsoon, crude price changes etc.
  - In case of **continuous deviation of actual inflation** from the target's tolerance bands for three consecutive quarters, the **RBI has to write a letter** to the GoI explaining the reasons for deviations and the time it will take to return inflation to its target. It thus **promotes Accountability**.

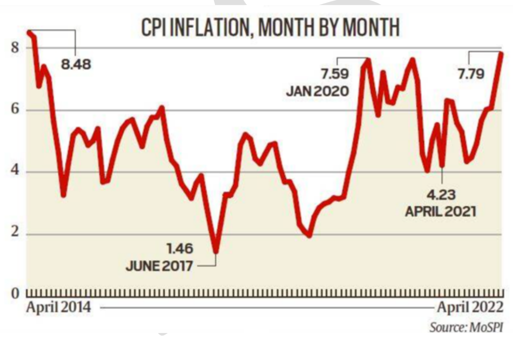
» **Section 45ZB** of the RBI Act, 1934 also provides for a **six member Monetary Policy Committee (MPC)** to be formed by government for inflation targeting. MPC consists of:

a. Governor of RBI - Chairperson of MPC - ex officio
b. Deputy Governor of the RBI, in charge of Monetary Policy – Member, ex officio.
c. One officer of the RBI to be nominated by the Central Board – Member, ex officio.
d. 3 external members nominated by GoI.

» The **decision is taken by majority** with the Chairperson having the casting vote. MPC conducts meetings at least four times a year (atleast every quarter) and monetary Policy is published after every meeting with each member explaining her opinion.

- **Before MPC**, all the interest rate related decisions were taken by Governor of RBI.
- Thus, the **MPC system replace individualistic decision-making by a collegial process** that brings in variety of experience, expertise and independence while avoiding groupthink and free-riding.

- **How has Flexible Inflation Targeting Worked so far?**
  - **Positives:**
    - FIT has been regarded as an important reform in country's economic management making it follow the **global best practices**.
      - It has promoted welfare of people, transparency, accountability and non-individualistic decision making system in RBI.



    - It has **effectively controlled inflation** as CPI has averaged 4.2%, between Sep 2016 and March 2020. Recent times have seen some fluctuation in inflation due to **COVID-19** supply disruptions, War in Europe and High Crude oil prices

  - Rating agencies and multilateral institutions have repeatedly mentioned the MPC and the inflation targeting framework as a **landmark structural reform towards sound macroeconomic management**.
  - **Negatives:**
    - **RBI hasn't been proactive and has remained behind the curve on inflation targeting**
    - **RBI has been very proactive on its non primary role** (i.e. dealing with decline in rupee (by selling forex); Keeping interest rates on government securities low, to help government finance its fiscal deficit; pay ample dividends to the government. With **RBI chasing five different targets,** it is hardly surprising that it lost sight of its inflation objective.
    - **Outside members of MPC** were supposed to give independent opinions. But the published minutes show that they haven't produced alternate inflation forecasts. Nor have they questioned the monetary strategy.

- **Conclusion:**
  - Inflation control is the lynchpin of macroeconomic stability which, in turn, is the foundation for sustained, inclusive growth
  - Considering the risks that the unanchoring of inflation and inflation expectation pose to macroeconomic stability, and the country's growth prospects, the central bank must continue to focus on maintaining price stability, attaching primacy to inflation targeting.

9. TRANSMISSION OF MONETARY POLICY: ISSUE OF STICKINESS IN BANK LENDING RATES

- **Introduction**
  - Stickiness in Bank lending refers to a situation where the RBI reduces its benchmark rates, but the benefit doesn't reach the final retail customers.
  - Banks tend to lower down the interest rates on deposits but doesn't reduce the interest rates on loans so swiftly.

- **Concerns due to this stickiness**
  - **Economic Growth** is negatively hampered and the purpose for which RBI reduces the policy rate is defeated.
  - **Small saving account holders** suffer as there deposits interest rate is reduced but loans still remain expensive.

- **Understanding Older System - BPLR, BASE Rate, MCLR System**
  - **Background (Prime Lending Rate)**
    - **Before the 1991 economic reforms**, lending rates of banks were **regulated by RBI**.
    - **Deregulation of lending rate:** In 1994, lending rate for **loans above Rs 2 Lakh were deregulated**. Banks could decide the lending rate based on risk perception and commercial judgment. Here bank was supposed to declare **Prime Lending Rate**, the rate that it would charge its most credit worthy customers.
    - In 2001-02, RBI permitted lending to credit-worthy customers at **sub-PLR rates**. This was done on the request of banks as well as to follow the international trend. So, PLR didn't remain the minimum lending rate anymore.

  - **BPLR System**
    - The rigidity and inflexibility in the PLR system, led to the introduction of **Benchmark Prime Lending Rate** (BPLR) system in **2003**.
      - The main objective was ensuring transparency in lending rate and not allowing exploitation of any section of borrowers.
      - Banks would fix BPLR with the approval of their board. However, RBI stipulated that the rate be influenced by the repo rate and CRR apart from the individual bank's policy.
      - BPLR was treated as reference for lending.
        - Clients with good credit will be offered rates below BPLR and those with risky credit, can be offered higher rates.
      - **Mis-use of BPLR**
        - Since, there was **no lower limit in BPLR**, it allowed banks to charge as low as 4% from big corporates (mostly because of lobbying) and charge high interest rate from retail borrowers (cross subsidization).

- This system turned out to be opaque as there was no mandated criteria to define the credit worthiness of a customer.
- Transmission of Monetary policy was also not ensured (and sometimes only ensured for new borrowers)

- **Base Rate System**
  - To deal with the problems of BPLR system (to achieve transparency in lending and transmission of monetary policy), RBI introduced **Base rate System** in 2010.
    - Base rate is the minimum lending rate prescribed by each commercial bank.
      - Banks (not RBI) fix this rate considering other factors and can't lend below this rate to attract borrowers. (**exceptions** include giving loans to employees, loans to bank depositors against their own deposits etc).
      - According to RBI policies, banks have to revise their base rate at least once every quarter.
      - Since 2010, it was mandatory for banks to offer new loans linked to base rate while NBFCs can still provide loans linked to prime lending rate.
    - This system was **successful in ensuring transparency**, but it **didn't ensure transmission of monetary policy**.
      - This was because banks used different methods to calculate base rates and used this flexibility to prevent transmission.
      - Further, sometimes only Base rates were changed and BPLR kept same, thus benefitting only new customers.

- **MCLR System**
  - The limitations of the BRS was intended to be overcome by the implementation of **Marginal Cost of Fund Based Lending Rates (MCLR)** system, which came into effect in April 2016.
    - This leaves banks with lesser flexibility while fixing lending rates.
      - All the loans sanctioned after April 1, 2016 have to be priced with reference to the marginal cost of fund-based lending rate (MCLR)

  - **Details**
    - MCLR is a **tenor linked internal benchmark**, which means the rate is determined internally by the bank depending on the period left for the repayment of loan.
    - MCLR is closely linked to deposit rates and is calculated based on **four components**:
      - The Marginal Cost of Fund
      - Negative Carry on account of CRR
      - Operating Cost
      - Tenor Premium

- **Two Main differences** from the Base Rate System
  - Under MCLR, the latest (at the time of review) rates offered on deposits or borrowings is taken into account.
  - The second major change is consideration of **Tenor Premium**.
    - It is a premium charged by banks to the borrower for the risks associated with the long-term tenor. The tenor premium is not specific to a loan class or borrower, and it will be uniform for a given residual tenor
    - Tenor Premium arises from loan commitments with longer tenors.
- **Advantages of MCLR**
  - Other than providing more transparency, it provides for better transmission of monetary policy.
  - The MCLR is based on current cost of funds for banks as compared to overall cost of funds for the banks. Thus MCLR rates are lower as compared to base rate.

- **Note:**
  - MCLR is the lowest interest rate that a bank or lender can offer. It is applicable for fresh corporate loans and floating **loans taken before Oct 2019. After this RBI has switched to the external Benchmark linked lending** rates (EBLR) system where lending rate is linked to benchmark rates like repo or Treasury Bill rates.

– **External Benchmark Linked Lending** Rates (EBLR)
  - RBI made it **mandatory for all banks to link floating rate loans** - to retail customers and loans to MSMEs to **an external benchmark from 1st of Oct, 2019**.
    - Bank can choose from one of the **four external benchmarks** - repo rate, three-month treasury bill yield, six monthly treasury bill yield, or any other benchmark interest rate published by Financial Benchmarks India Limited.
    - **Adoption of multiple benchmark** by the same bank is not allowed within a loan category.
    - Banks are allowed to decide on the **spread** over the external benchmark, **credit risk premium** can change only when borrower's credit assessment undergoes a substantial change.
    - Other components of **spread**, including operating cost, could be altered once in three years.
    - **Interest rate** under external benchmark shall be reset at least once in three months.
    - **Existing customers** under MCLR system with floating rate are eligible to switchover to the new external benchmark without any charges.
  - **Banks have linked their EBLR to the RBI's Repo Rate**.
  - **Why?**

- Faster transmission of monetary policy. RBI had found transmission of monetary policy under MCLR framework as not satisfactory.
- **Note:** The share of EBLR loans in total advances was 39.2% in Dec 2021 according to RBI.

– **Recommendation of Janak Raj Committee**
  - Key Highlights

    i. All floating rate loans advanced from April could be referenced to **one of the three external benchmarks**.
    - The committee has recommended a risk free curve involving rates on treasury bills, or certificate of deposits rates, or the RBI's repo rate.

    ii. Lending rate should be reset once every quarter, from the current practice of once a year.

    iii. Transfer all existing borrowers under BPLR, Base Rate or MCLR to the external benchmarked rate without any conversion fee or other charges within one year of its introduction
  - **Other observations**
    - **Arbitrariness of banks** in calculating MCLR and Base rate is leading to lower transmission of monetary policy
      - The spreads charged over these internal benchmarks has undermined the integrity of the interest rate setting process. In some cases, the tenor and risk premium charged was different for customers in the same risk category.

10. PRIORITY SECTOR LENDING (PSL)

– **Introduction:** In order to ensure all round development of the economy, RBI mandates banks to provide a specified % of the bank lending to few specific sectors like Agriculture and allied activities, MSME, Education, weaker section etc. This lending is known as priority sector lending.
  - **Rationale or Need of such norms:** Loans/credit to certain sectors may not be very profitable for banks and thus are ignored. But, these sectors are crucial for the development of the country and inclusive growth. Therefore, RBI mandates compulsory lending to these sectors.

– **Different Sectors/Categories under Priority Sector** (As on Oct 2023)

i. Agriculture
ii. Micro, Small and Medium Enterprise
iii. Export Credit
iv. Education
v. Housing
vi. Social Infrastructure
vii. Renewable Energy
viii. Others

– **Targets / Sub-targets for banks under priority sector (Oct 2023)**

Categories	**Domestic commercial banks (excl. RRBs & SFBs) & foreign banks with 20 branches and above**	**Foreign banks with less than 20 branches**	**Regional Rural Banks**	**Small Finance Banks**
Total Priority Sector	40 per cent of ANBC or CEOBE whichever is higher.	40 per cent of ANBC or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector.	75 per cent of ANBC or CEOBE whichever is higher; However, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15 per cent of ANBC.	75 per cent of ANBC or CEOBE whichever is higher.
Agriculture	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18 per cent ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for SMFs	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent is prescribed for SMFs
Micro Enterprises	7.5 per cent of ANBC or CEOBE, whichever is higher.	Not applicable	7.5 per cent of ANBC or CEOBE, whichever is higher	7.5 per cent of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12 percent of ANBC or CEOBE, whichever is higher.	Not applicable	15 per cent of ANBC or CEOBE, whichever is higher	12 percent of ANBC or CEOBE, whichever is higher

- **Note:**

- **ANBC**: Adjusted net bank credit
- **CEOBE:** Credit Equivalent of Off-Balance Sheet Exposures

– **Targets/ Sub-Targets for UCBs**

Categories	Primary Urban Cooperatives
Total Priority Sector	40% of ANBC or CEOBE whichever is higher, in FY20, which shall stand increased to **75%** of ANBC or CEOBE, whichever is higher, wef from FY26.
Micro Enterprise	7.5% of ANBC or CEOBE, whichever is higher
Advances to Weaker Section	12% of ANBC or CEOBE , whichever is higher. The revised target for weaker section will be implemented in a phased manner from 10% in FY20 to 12% in FY26.

– **Adjustments for weights in PSL Achievements**:
  - To address regional disparities:
    - From FY22 onwards, a higher weight (125%), would be assigned to the incremental priority sector credit in the identified districts where the credit flow is comparatively lower (per capita PSL less than Rs 6,000), and a lower weight (90%) would be assigned for incremental priority sector credit in the identified districts where the credit flow is comparatively higher (per capita PSL greater than Rs 25,000).

– **Agriculture sector is further classified under** three subcategories viz. Farm Credit, Agriculture Infrastructure and Ancillary Activities.

– **What is included under Weaker section under PSL**
  - Priority sector loans to following borrowers are eligible to be considered under weaker section category:
    i. Small and marginal farmers
    ii. Artisans, village and cottage industry where individual credit limit doesn't exceed Rs 1 Lakh.
    iii. Beneficiaries under NRLM, NULM, Self-Employment Scheme for rehabilitation of manual scavengers
    iv. SCs and STs
    v. Beneficiaries of Differential Rate of Interest (DRI) Scheme
    vi. SHGs
    vii. Distressed farmers indebted to non-institutional lenders
    viii. Distressed person (other than farmers), with loans not exceeding Rs 1 Lakh per borrower to pre-pay their debt to non-institutional lender.
    ix. Individual women beneficiary upto Rs 1 Lakh per borrower
    x. Person with disabilities
    xi. Minority communities as may be notified by Government of India from time to time.

– **What are priority sector lending Certificates (PSLCs)**

- It is a mechanism to **enable banks to achieve their PSL targets and sub-targets by purchase of these instruments in the event of shortfall**.
- This also incentivizes surplus banks as it allows them to sell their excess achievement over targets and thereby enhancing lending to categories under priority sector.
- In this mechanism there is no transfer of risk or loan assets.

– **Is rate of interest different for PSL**
  - The guidelines don't lay down any preferential rate of interest for priority sector.

– **What happens when bank doesn't meet the target?**
  - They have to invest an amount equal to the shortfall to Rural Infrastructure Development Fund **(RIDF** - it came into existence in 1996) maintained by NABARD.
    - » The primary purpose of RIDF is to encourage commercial banks to meet their targets.
    - » Interest rate levied on RIDF varies from two to four percent below bank rates depending on the extent of shortfall in PSL targets.