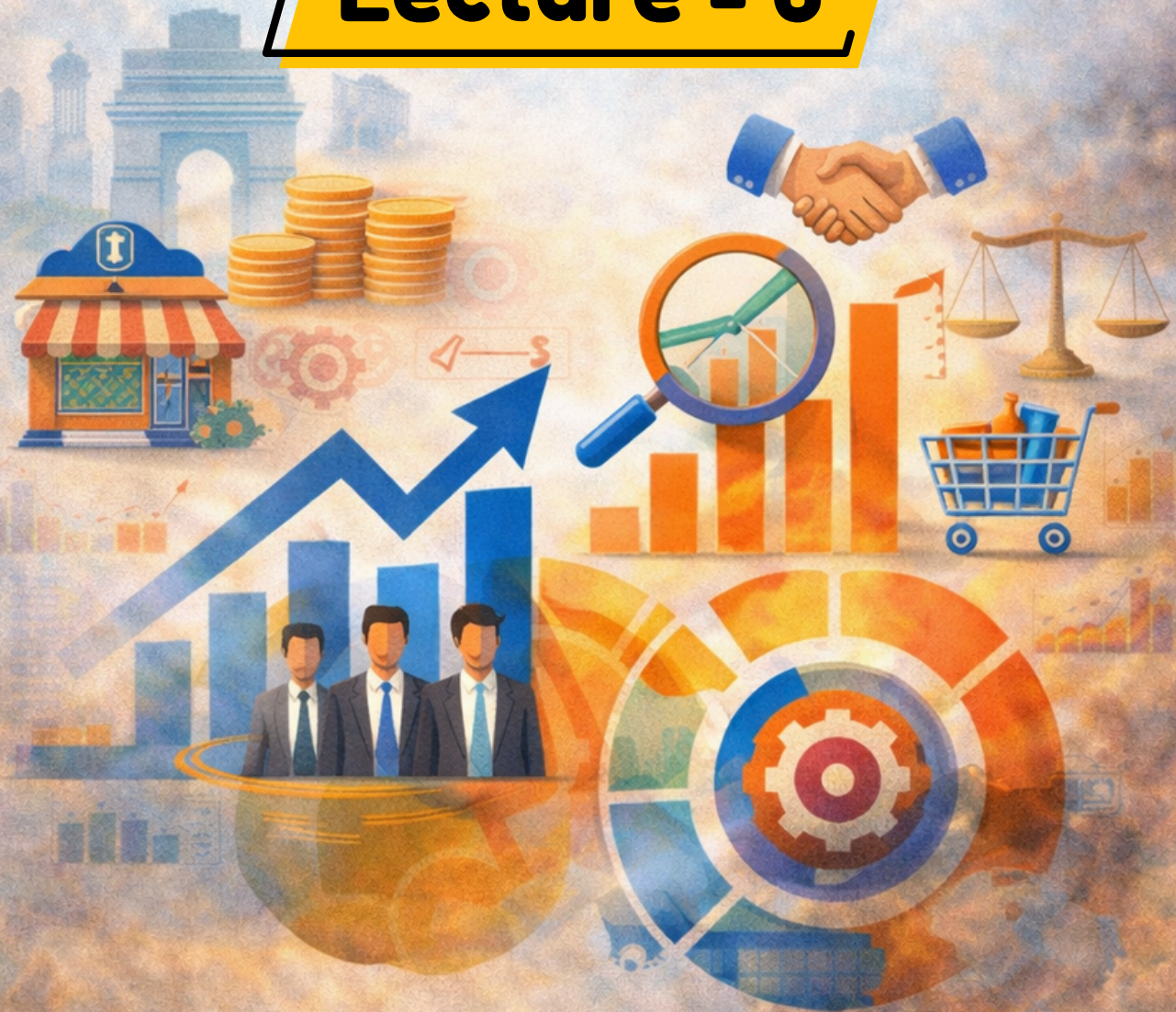
PARMAR SSC

MONETARY POLICY

Lecture - 6



BY PARMAR SIR

BASICS OF BANKING & BALANCE SHEET

The Business of Banking

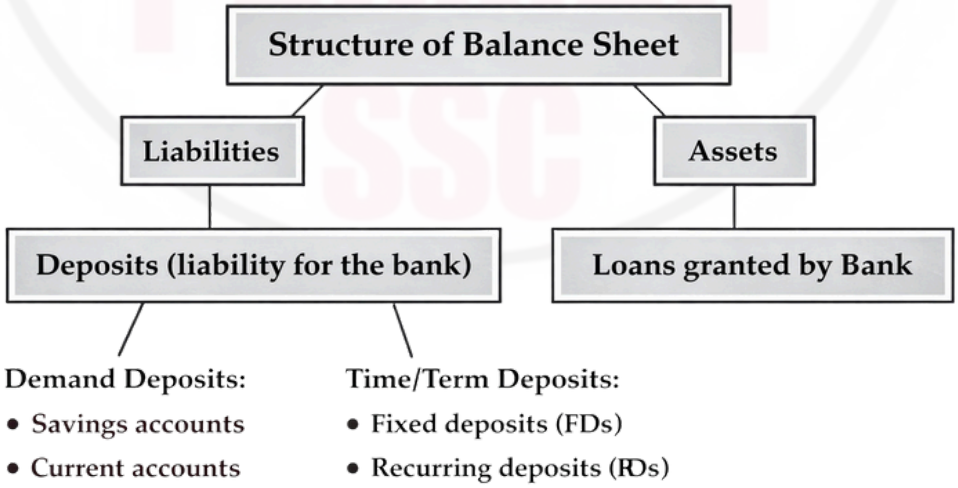
- **Primary Function:** Banks accept Deposits from the public and provide Loans to borrowers.
- **The Spread:** The difference between the interest rate charged on loans (e.g., 9%) and the interest rate paid to depositors (e.g., 7%) is the bank's profit, known as the Spread.

Balance Sheet

- A bank's balance sheet is a financial statement that shows its Assets (what the bank owns) and Liabilities (what the bank owes to others, including depositors).

The Balance Sheet: Assets vs. Liabilities

Component	Classification	Reason
Deposits	Liability	The bank owes this money to the public. It must be returned upon demand or maturity.
Loans	Asset	This money works for the bank. It generates income (interest) and is "owned" by the bank until repaid.



Net Demand and Time Liabilities (NDTL)

- Net Demand and Time Liabilities (NDTL) refers to the total deposits held by a bank, which determines the funds available for lending.
- It is a crucial factor in calculating the reserve requirements mandated by the Reserve Bank of India (RBI).

Types of Deposits (Liabilities)

- The total deposits held by a bank are referred to as NDTL (Net Demand and Time Liability).

1. Demand Liabilities (Demand Deposits):

- Money can be withdrawn at any time (On demand).
- **Examples:** Savings Accounts, Current Accounts (Used for business, usually 0% interest).

2. Time Liabilities (Term Deposits):

- Money is locked for a fixed tenure.
- Withdrawal before maturity attracts a penalty.
- **Examples:** Fixed Deposits (FD), Recurring Deposits (RD).

Note: Banks prefer Time Deposits because the funds are stable, allowing them to lend more aggressively.

RESERVES MAINTAINED BY BANKS

- RBI keeps a part of NDTL as a reserve.
- This is done to ensure that Banks have sufficient vault cash to cater any emergency situation.

This is done through two mechanisms:

1. Cash Reserve Ratio (CRR)

- **Definition**: A specific percentage of a bank's NDTL that must be kept with the RBI.
- **Form:** Must be maintained in Cash only.
- **Interest**: Banks earn NO interest on CRR.
- **Purpose**: To ensure liquidity and safety of depositors' money.
- **Current Trend mentioned:** Roughly 3% (variable).
- **Floor Limit:** The RBI amendment removed the "floor limit" for CRR, meaning RBI can reduce it below previous statutory limits if needed.

2. Statutory Liquidity Ratio (SLR)

- **Definition**: A percentage of NDTL that banks must maintain with themselves (in their own vaults).
- **Form**: Can be maintained in Cash, Gold, or Government Securities (G-Secs).
- **Interest**: Banks earn interest on this (specifically on the component invested in G-Secs).
- **Current Trend mentioned:** Roughly 18% (variable).
- **Committee Recommendation:** The 1991 Narasimham Committee recommended that statutory requirements like SLR should be reduced so that banks would not be forced to lock up large funds in government securities. However, banks continue to hold government securities for safety, liquidity, and stable returns.

Comparison Table: CRR vs SLR		
	CRR	SLR
Where kept	With RBI	With Bank itself
Form	Cash Only	Cash, Gold, G-Sec
Return	No Interest	Earns Interest

Penalties (RBI Act 1934 - Section 42(3))

- If a bank fails to maintain the required CRR/SLR:
- **First Default:** Bank Rate + 3% penalty.
- Subsequent Default: Bank Rate + 5% penalty.

MONETARY POLICY

- Monetary policy refers to the regulation of the money supply and interest rates by the RBI to maintain price stability, control inflation, and ensure economic growth.
- RBI uses various monetary policy tools to achieve these objectives, which are categorized into quantitative and qualitative instruments.

MONETARY POLICY TOOLS

- These tools control the volume/quantity of money in the economy.

1. Cash Reserve Ratio (CRR)

2. Statutory Liquidity Ratio (SLR)

3. Bank Rate

- **Definition:** The interest rate at which RBI lends to commercial banks for Long Term needs.
- **Usage:** Used for long-term lending to banks and the government.
- **Collateral:** No collateral (security) is required.

COLLATERAL

Collateral is something valuable that a borrower gives as a guarantee for a loan. If the borrower fails to repay, the lender can take the collateral to recover the money.

Higher bank rates make borrowing costlier, reducing money supply and lower bank rates make loans cheaper, increasing liquidity.

4. Open Market Operations (OMO)

- It is also called as Sterilization.
- **Definition:** Buying and selling of Government Securities (G-Secs) by the RBI in the open market.
- **Types:**

1. **Outright Purchase:** RBI directly buy or sell government securities without any kind of repurchase agreement.
2. **Repurchase Obligation (Repo):** When banks borrow money from RBI, using government securities as collateral and with a promise of repurchasing them later, it is called as Repo. Similarly, when RBI invites bank to deposit their extra funds in RBI in exchange of government securities, it is called as Reverse Repo.

Liquidity Adjustment Facility (LAF)

- It is the framework through which the Reserve Bank of India manages short-term liquidity in the banking system. Earlier, Repo and Reverse Repo together formed the LAF.
- From 2022-23, the Reverse Repo rate was removed from the LAF framework and replaced by the Standing Deposit Facility (SDF) rate, which now acts as the floor of the interest rate corridor.
  - Standing Deposit Facility (SDF) allows banks to park surplus funds with RBI without providing any collateral. It is a liquidity absorption tool and helps RBI control excess liquidity more effectively.

The legal provision for the SDF scheme was introduced in the Union Budget 2018-19, but the facility was operationalised by RBI in 2022.

5. Marginal Standing Facility (MSF)

- Marginal Standing Facility (MSF) is an emergency lending facility introduced in 2011-12, under which banks borrow money from the Reserve Bank of India when they face an acute shortage of funds. It provides overnight loans at a penal interest rate, which is usually 1 % (100 basis points) higher than the repo rate.
- Under MSF, banks are required to provide collateral, and they are allowed to use government securities (G-Secs) from within their SLR quota, meaning they can dip into their mandatory reserves. This facility acts as a last-resort option for banks in extreme situations. Only scheduled commercial banks are eligible to access the MSF.
- **Borrowing Limit:** The limit for such borrowing is generally 1 or 2% of NDTL (Net Demand and Time Liabilities)

BASE RATE & INTERBANK LENDING MARKET

Base Rate

- The minimum rate below which banks are not allowed to lend money except in cases specified by the Reserve Bank of India

Interbank Lending Market

- **Why it happens:** Banks borrow short-term funds from each other to manage liquidity and regulatory requirements.

Call Money Rate

- **Definition:** This borrowing takes place at the Call Money Rate. It is the interest rate charged for short-term, overnight loans between banks and financial institutions.
- ***Duration:*** As per the handwritten note, this is specifically for less than a day (overnight).
- **How it is decided:** The rate is determined based on the RRR (Reverse Repo Rate) and MSF (Marginal Standing Facility).

Money Market Durations

- **Call Money:** For 1 day (Overnight / Less than a day).
- **Notice Money Market:** For a duration of 2 to 14 days.

MONETARY POLICY COMMITTEE (MPC)

- **Establishment:** 2016, based on the Urjit Patel Committee recommendations.
- **Structure:** 6 Members.
  - 3 from RBI (includes Governor, Deputy Governor, Executive Director).
  - 3 appointed by the Government of India.
- **Chairperson:** RBI Governor (has the casting vote in case of a tie).
- **Function:** Decides the policy rates (Repo, etc.) to control inflation.
- **Meeting Frequency:** Bi-monthly (Every 2 months).

MONEY MULTIPLIER (MM)

- The Money Multiplier (MM) is the highest possible extent to which the money supply can increase due to changes in bank deposits.

$$\text{Money Multiplier} = \frac{1}{\text{CRR}}$$

NBFC and NBFC-MFI need not maintain CRR and SLR

- When CRR increases, banks keep more money as reserves. They have less money to lend. Fewer loans mean less money creation. This reduces the money multiplier and vice versa.

Situation	RBI Action	Effects	Policy
During inflation	Increase in CRR, SLR, BR, RRR, RR	Decrease in money supply	Contractionary/ Tight/Dear/Hawkish Monetary Policy
During deflation	Decrease in CRR, SLR, BR, RRR, RR	Increase in money supply	Expansionary/Easy/ Dovish Monetary Policy

QUALITATIVE MONETARY POLICY TOOLS

- These are selective tools used by RBI to control the use and direction of credit in specific sectors of the economy. The central bank limits the amount of loans and advances that commercial banks can give.

1. Changing Margin Requirements

- The RBI increases the margin (the amount borrowers must pay upfront) for non-essential sectors to limit excessive borrowing and reducing it for important sectors like agriculture to encourage lending.

2. Consumer Credit Regulation

- RBI sets rules on loan installments, down payments, and repayment periods in advance. This helps manage inflation by controlling how much people can borrow.

3. Moral Suasion

- It is a technique used by RBI to influence economic activity through persuasion and implicit threats. RBI advises or persuades banks to follow its monetary policy.

4. Credit rationing

- Credit rationing is when RBI limits the total amount of loans and credit banks can issue to certain sectors. It fixes the credit supply for each bank, preventing excessive lending. It also sets credit limits for different sectors to ensure balanced lending.

FISCAL POLICY

- Fiscal policy is the government's strategy to manage the economy by adjusting taxes, government spending, and borrowing. It is used to control inflation or deflation, unemployment, and economic growth.

When the government wants to control inflation, it can take the following steps:

- **Increased Taxes:** Higher taxes reduce people's disposable income, leading to lower spending and demand.
- **Lower Subsidies:** Reducing subsidies makes goods and services more expensive, discouraging excessive consumption.
- **Lower MSP (Minimum Support Price):** A lower MSP discourages excessive crop production and controls the rise in food prices by keeping supply in check.



MSP stands for Minimum Support Price, a price set by the government for certain agricultural products.
Monetary Policy is used by RBI and Fiscal Policy is used by Government.



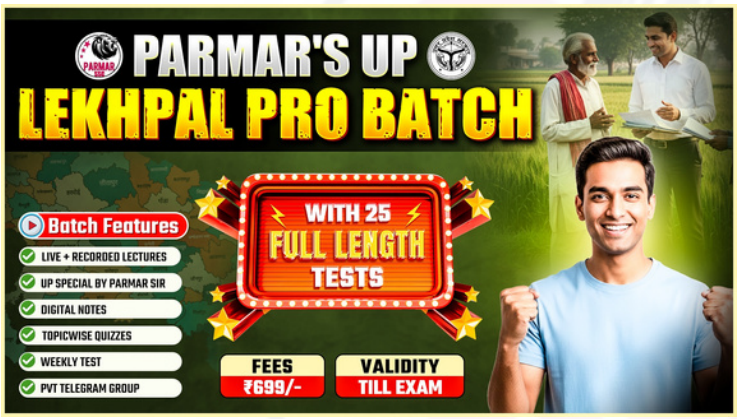


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