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ECONOMY

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MONETARY AND CREDIT POLICY

Monetary and Credit Policy

Reserve Bank of India

Functions of RBI

Control of Credit - Monetary Policy

How does such control of RBI affects economy?

Net Demand and Time Liabilities (NDTL)

Quantitative control

Cash Reserve Ratio (CRR)

Statutory Liquidity Ratio (SLR)

Bank Rate

Liquidity Adjustment Facility (LAF) Repo, Reverse Repo

Marginal Standing Facility (MSF)

MSF vs LAF

Open Market Operations (OSO)

Qualitative control

Indian Banking

Two Phases

A. 1969-1991 → Post Nationalisation

B. 1991-Present → Banking Reforms

- * Largest Bank – State Bank of India, Nationalised in 1955

Bank Nationalisation

- * Bank Nationalisation ordinance 1969
- * Bank Nationalisation Act 1970
- * 14 Banks Nationalisation in 1969, having a criteria of deposits 50Cr and above
- * 6 banks Nationalised in 1980, having a deposit criteria of 200 crores and above
- * New bank of India was later merged with PNB in 1993.

Scheduled Commercial banks

- * Banks we deal on day 15 day basis
- * Listed in the II schedule of the RBI Act 1934, which lays down 2 cdns namely
 - i. They have a paid up capital of 5 lakhs and above
 - ii. Must necessarily function in the interest of the depositors.
- * Scheduled banks enjoy RBI Patronage.

Bank Nationalisation

- * To prevent concentration of economic power
- * To spread banking to the length and breadth of the country
- * To change from class 15 mass banking
- * To mobilized deposits for investment
- * To inculcate banking habit with people
- * To cater to Agri. and rural sector
- * To develop a pool of professional bankers through bank P.O exams.

Advantages

- * Branch expansion from app 8000 to 60000 branches
- * Deposit mobilization rose to 8-9 lakh crores from 4000 lakh
- * Serve as engines of growth through increasing the investment rate and economic growth
- * To serve as agents of change by financing PAP programmes and employment generation programmes.
- * Credit disbursement from consumption based to production based.
- * Credit to Agri. sector – 40% PSL in which 18% goes to agri.
- * Diversification of operation from core banking to Merchant Banking, Mutual funds, higher purchase etc.



Disadvantages

- * Developments contrary 15 interests of banking sector
 - 1 Erosion of profitability
 - 2 Non Performing Assets (NPA)
 - 3 Bad Recovery
 - 4 Sickness in banking industry

Reasons

- * Indiscriminate branch expansion
- * High CRR & SLR
- * Priority sector lending - High-40%
- * Lack of prudential banking norms
- * Lack of transparency in Balance sheets, Book keeping etc.
- * No stipulation of capital adequacy
- * Lack of proper customer service and satisfaction due to monopoly market
- * High political interference
- * Loan waivers and melas
- * No Recovery mechanism for bad assets

Schemes introduced from 1969-91

- A. Lead Bank Scheme (1969): Banks to identify credit gaps-problems and to chalk out plans to address it. Also each public sector bank is allotted a dist to develop its potential.
- B. Differential Interest Rate scheme (1972): Loan to below poverty line at 4%, also 1% of total deposits of previous year to be directed to below poverty line
- C. Service Area Approach (1989): Part of lead bank scheme in which a cluster of 15-25 villages is to be adopted by each bank for development.

Major Banking Terminologies**Call Money**

- * Also known as Money at Short notice
- * Refers to Interbank transactions on a day to day basis (banks lending between each other)
- * Important and most sensitive segment of money market service.
- * It determines whether money market is flush with funds or not.
- * High Call rate → Credit Scarcity in market
- * Low Call rate → Credit Surplus in market

Prime Lending Rate

- * Rate of interest, a bank charges on its prime blue chip high credit worth customers (Corporate borrowers)
- * Sets the benchmark of interest rate which a bank charges



- * Sole authority to issue currency under the system of Minimum Reserve.
- * Bankers Bank.
- * Government's Bank, because it conducts borrowing programmes on behalf of governments through sale of governments bonds and securities.
- * Sole authority in terms of Forex Reserves.
- * Guardian of Money Market.
- * Determines the Exchange Rate based on Market variations w.r.t Inflation/Deflation, Trade weight (REER) (NEER).
- * Controller of Credit (what commercial banks lend as loans)
- * Acts as the lender of last resort.
- * Performs promotional and developmental activities by promoting certain Apex Institutions for specific purposes.

Control of Credit - Monetary Policy

Credit policy is a part of Monetary policy(RBI) as it deals with how much and at what rate credit is advanced by Banks.

Simply put, Loans given by banks is controlled by RBI.

Two types of control

1. Quantitative control
2. Qualitative control

Quantitative control

Controls the quantum of Loans given by Commercial Banks.

Tools used

- * Cash Reserve Ratio (CRR).
- * Statutory Liquidity Ratio (SLR).
- * Bank Rate.
- * Marginal Lending Facility (MSF)
- * Liquidity Adjustment Facility (LAF) Repo, Reverse Repo
- * Open Market Operations.

Qualitative control

Apart from Quantum control of credit. RBI also controls the Purpose and Direction for which loans are given by banks.

These are selective measure to meet the Priorities of the Economy.
(Ex. Agri. Infra.)

Tools used



- * Credit Rationing.
- * Moral Persuasion.
- * Margin requirement variation.

These methods of qualitative and quantitative control does the following functions

- * Credit accessibility and quality
- * Credit availability
- * Price stability
- * Exchange rate stability
- * Interest rate stability
- * Generates employment
- * Generates growth
- * Macroeconomic stability
- * Controls Inflation
- * Generates or Reduces demand
- * Liquidity management etc.

How does such control of RBI affects economy?

Monetary policy can be **Contractionary or Expansionary**

RBI's various tools are pegged with an Interest rate. Now as a common man we will park our money in the place that gives more interest to our money.

Same way, Banks with huge chunk of money also needs to earn profit to survive. Now if the RBI offers high Interest, these guys will choose RBI to park their money instead of risky loans and investments to gain profit.

Likewise if the RBI reduces the Interest rate then to earn profit the banks instead of parking money in RBI will be ready to give loans even though they are risky and also will tempt common man to get take more loans by offering good interest rate.

Contractionary Policy

- * Raising interest rates to control Inflation. Tightens credit flow in the country
- * Normally when there is **Liquidity** (lot of money in market), Demand will be more, -> causing Rise of Price -> causing Inflation.
- * To stop/control inflation RBI will raise their interest; Now Banks will divert money from market to RBI causing a

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scarcity in cash flow -> Reduced money supply -> Reduces demand -> Reduces Inflation.

Expansionary policy

- * Increases the total supply of money in the Economy to beat recession/slowdown.
- * Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates,
- * When there is **Recession** (lesser economic activity) -> less money supply will be present.
- * Now to Increase money supply (Liquidity) -> RBI reduces interest -> Banks will divert money from RBI to market -> Increased Liquidity -> More loans -> More money in hand -> Increases demand -> Causing growth.

This way RBI has a control over economy. Recent News about Fed rate changes(American Central bank) are on the same link, to increase economy fed maintained 0% interest rate post financial crisis 2008.

SO in all it can be summed up that RBI's role in Monetary policy is **controlling Liquidity**.

RBI uses different tools on the same line to control Inflation / Growth, but each tools has different operational period (short term/long term).

Net Demand and Time Liabilities (NDTL)

Any calculation of banks reserve are made as per NDTL, which includes

Demand liabilities (connected to any time operatable funds)

1. Savings Account money
2. Current Account money
3. Demand Drafts
4. other Unclaimed Deposits

Time Liabilities (connected to period based operation 6 months, 3 months etc)

1. Fixed Deposits Money
2. Cash Certificates
3. Gold Deposits

Government securities:
Treasury bills (T-Bills), Dated securities.

These are sold by government through RBI to banks or to public.

Government securities are nothing more than agreement between concerned party and govt. that they can be traded for money. This way the

4. Staff security deposit

Now this NDTL of Banks/ financial institutions is controlled by RBI with many tools

Quantitative control

Cash Reserve Ratio (CRR)

- * It is the ratio of total demand and time liabilities it **with** the **RBI**.
- * If CRR Increases - Credit Squeeze - during Inflation.
- * If CRR Decreases - Credit Liberalize -during Recession.

Statutory Liquidity Ratio (SLR)

- * Ratio of total deposits of a bank which it has to statutorily maintain **with itself** in liquid form.
- * Government securities, Gold and Cash are the liquid forms.
- * SLR is only in India because of the fear of insolvency and government trade with banks.

SLR + CRR the Reserve ratios are huge volume of NDTL of the bank held idle to avoid any financial problem. Such holding levels (value) as specified by RBI must be informed to RBI every fortnight by Banks.

So leaving this amount the banks are allowed to exploit the remaining reserve for their profit, but here too many tools are used to control them creating a liquidity control.

Bank Rate

- * It is the rate at which RBI lends to commercial banks.
- * Rate at which the RBI gives Refinancing facilities on rediscounting bills of exchange to commercial banks without keeping any collateral.
- * IF Bank Rate Increase - **Dear money** policy.
- * If Bank Rate Decrease - **Cheap money** policy.
- * Bank Rate is **Long term liquidity**.

Liquidity Adjustment Facility (LAF)

- * LAF was introduced in 1992 as an interim measure and made a complete full term tool in 2000.



- * Liquidity Adjustment facility is the short term money supply(liquidity) adjustment, LAF covers credit at **Repo and Reverse Repo rates**.
- * Purpose is to even our **Short term** fluctuations in money market on day to day basis

Repo Rate: It is the rate at which RBI **buys** securities from its clients in order to inject **liquidity**

What Bank rate does in longterm Repo does in short term

Reverse Repo rate: It is the rate at which RBI **sells** government securities to commercial banks to **mop up surplus** credit from the market by selling government securities with a promise to repurchase them.

In LAF RBI not only deals with commercial banks but also many others termed as clients of RBI

- * Central Government
- * State Governments
- * Banks (Commercial, Regional Rural banks, Cooperative banks)
- * Non-Banking Financial Institutions etc

Marginal Standing Facility (MSF)

- * Introduced in 2011
- * In MSF only Scheduled Commercial banks can borrow from the RBI at a rate 1% more higher than Repo rate.
- * Banks can borrow money through MSF when there is considerable shortfall of Liquidity for its operation but at higher rate of interest.
- * Each Banks can borrow only 2% of the value of their total deposits through MSF window.
- * MSF is more like penal (punitive) tool for banks,

MSF vs LAF

- * The transactions of MSF and LAF takes place by trading of Government securities with RBI.
- * While in LAF the banks can use only those government securities held **in addition** to /over that of their SLR holding (ie banks cannot use SLR government securities in LAF), but MSF they can breach even the Government securities held under SLR.



- * MSF -> Only scheduled commercial banks, LAF -> Clients of RBI.
- * MSF window become necessary because repo operations are limited to specific period during the day.

In 2011, Bank rate was aligned with newly introduced Marginal Standing Facility (MSF). which in turn is linked with Liquidity Adjustment Facility (LAF).

Tool	Purpose	Impact on Liquidity	Relation to Other Tools
Repo Rate	Lend to banks, inject liquidity	Increases	Sets benchmark; influences reverse repo, MSF
Reverse Repo	Absorb excess liquidity	Decreases	Below repo rate, part of LAF corridor
MSF	Emergency lending to banks	Increases (costly)	Above repo rate, penal rate for liquidity
Bank Rate	Long-term lending rate	Varies	Aligned with repo/MSF, less active tool
CRR	Reserve requirement	Decreases (if high)	Reduces lendable funds, structural control
SLR	Investment in securities	Decreases (if high)	Complements CRR, supports govt borrowing

JUNE 2025 Rates:

Repo Rate: 5.50%

Reverse Repo Rate: 3.35%

Marginal Standing Facility (MSF) Rate: 5.75%

Bank Rate: 5.75%

Cash Reserve Ratio (CRR): 3.00%

Statutory Liquidity Ratio (SLR): 18.00%

Open Market Operations (OSO)

- * It is conducted by RBI (directly), by way of Selling and Buying Government securities in the open market.
- * While in MSF or LSF these securities are traded between Banks and RBI with a guarantee of being bought back (Temporarily).
- * In OSO these securities are sold directly and Permanently.



- * Generally RBI sells more of these during Inflation, to arrest liquidity.

Qualitative control

Credit Rationing

- * Giving letters to banks and fixing the priorities of sectors the banks have to invest.
- * Ex: Priority Sector Lending (PSL). Loans to below poverty line people (BPL). Contribution to Rural infrastructure development fund.

Moral Persuasion

Of Erring banks. If RBI directions are not obeyed,

RBI resorts to

- * Cancellation of license.
- * Penalizing Banks.
- * Regulating consumer trend – consumption based loans to production based loans.

Variation in Market Requirement - Generally in essential commodities.

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