

Banking & Monetary Policy

Banking in India:

- Banking is the business of accepting deposits from the public and lending those deposits to others, either for consumption or productive purposes.
- It plays a key role in mobilizing savings and channeling them into investment.
- In India, banks are governed mainly under the Banking Regulation Act, 1949 and supervised by the Reserve Bank of India (RBI).
- RBI was established in 1935 under the RBI Act, 1934 and was nationalized in 1949.

Structure of Indian Banking System

A. Scheduled Banks

- Banks listed in the Second Schedule of the RBI Act, 1934.
- They maintain a minimum Cash Reserve Ratio (CRR) with the RBI and enjoy certain facilities like borrowing from RBI at the bank rate.

B. Types of Scheduled Banks

1. Commercial Banks
 - Operate on a profit basis and provide banking services to individuals and businesses.
 - Public Sector Banks: Majority owned by the Government (e.g., SBI, PNB)
 - Private Sector Banks: Owned by private entities (e.g., HDFC Bank, Axis Bank)
 - Foreign Banks: Headquartered abroad but operating in India (e.g., Citibank)
 - Regional Rural Banks (RRBs): Focused on rural banking and agriculture credit.
2. Co-operative Banks
 - These are owned and operated by members for mutual benefit, often at state or district level.
 - Dual regulation by RBI and Registrar of Co-operative Societies.
3. Payments Banks
 - New type of bank launched to further financial inclusion.
 - Can accept deposits (max ₹2 lakh per account) but cannot lend loans.
 - Provide services like ATM/debit cards, mobile banking.

4. Small Finance Banks (SFBs)

- Provide basic banking services to underserved sections like small farmers, MSMEs.
- Can accept deposits and lend.

Banking Terms

- **CRR (Cash Reserve Ratio):**
Portion of a bank's total deposits that must be kept with the RBI in cash form, without earning any interest. It's a tool to control liquidity in the system.
- **SLR (Statutory Liquidity Ratio):**
A fixed percentage of net demand and time liabilities (NDTL) that banks must maintain in the form of government securities or other approved securities before providing credit.
- **Repo Rate:**
The rate at which RBI lends money to commercial banks for short durations. It's the main tool for managing short-term inflation and liquidity.
- **Reverse Repo Rate:**
The rate at which RBI borrows money from banks. It helps absorb excess liquidity from the market.
- **Bank Rate:**
Long-term lending rate of the RBI to banks without any repurchase agreement (repo). It influences long-term interest rates.
- **MSF (Marginal Standing Facility):**
A facility that allows banks to borrow overnight funds from RBI against securities when they run out of eligible securities for repo.
- **Base Rate / MCLR:**
Minimum interest rate set by the bank below which it cannot lend, except for certain cases. MCLR (Marginal Cost of Lending Rate) replaced base rate in 2016 to ensure transparency.
- **Call Money:**
Short-term interbank loans for one day. Interest rate in this market indicates liquidity in the system.
- **NPA (Non-Performing Asset):**
A loan or advance for which principal/interest payment is overdue for more than 90 days. NPAs weaken the bank's profitability and capital.

Reserve Bank of India (RBI)

- Central bank of India and monetary authority.
- Functions:

- Currency issuance (except ₹1 which is issued by the Ministry of Finance).
- Maintains monetary stability through policy tools.
- Banker to the Government.
- Lender of last resort to banks.
- Regulates and supervises banks, NBFCs, payment systems.

Monetary Policy:

- It's a macro-economic tool used by the RBI to control:
 - Inflation
 - Money supply
 - Credit availability
 - Economic growth
- Implemented through monetary policy instruments to ensure price stability and support growth.
- Governed by the Monetary Policy Committee (MPC).

Types of Monetary Policy

A. Expansionary Monetary Policy

- Aim: Increase money supply → stimulate growth.
- RBI reduces repo rate, CRR, SLR → more credit → investment ↑
- Used in recession or slowdown.

B. Contractionary Monetary Policy

- Aim: Reduce inflation and control overheating economy.
- RBI increases repo rate, CRR, SLR → costlier credit → demand ↓

Tools of Monetary Policy

1. Quantitative Instruments (general impact on economy)

- Repo Rate
- Reverse Repo Rate
- CRR
- SLR
- Open Market Operations (OMO):
 - RBI buys/sells government bonds in open market to inject/suck liquidity.

2. Qualitative Instruments (sector-specific)

- Moral Suasion: RBI persuades banks to follow guidelines.
- Margin Requirements: Controls how much loan is given against securities.
- Credit Rationing: Limits credit to certain sectors to control speculative demand.
- Selective Credit Control: Restrictions on credit for specific commodities (e.g., sugar, wheat).

Monetary Policy Committee (MPC)

- Established under RBI Act, 1934 (Amended in 2016).
- Composition:
 - 6 members – 3 from RBI (including Governor) + 3 nominated by Government.
- Governor = Chairperson
- Decisions taken by majority vote, each member has one vote.

Inflation Targeting Framework

- Adopted by RBI in 2016.
- Based on Urjit Patel Committee recommendations.
- Mandate: Maintain inflation at $4\% \pm 2\%$.
- Current term (2021–26): same band.
- Measured by: CPI (Consumer Price Index)

Important Schemes and Reforms

- Pradhan Mantri Jan Dhan Yojana (PMJDY):
 - National mission for financial inclusion, zero balance accounts.
- Banking Correspondents (BCs):
 - Agents appointed to deliver banking services in remote areas.
- Aadhar Enabled Payment System (AEPS):
 - Allows banking transactions via Aadhar-linked biometric authentication.
- Unified Payments Interface (UPI):
 - Real-time inter-bank payment system.
- Prompt Corrective Action (PCA):
 - Framework to monitor weak banks based on parameters like CRAR, NPA.

- Basel Norms:
 - International capital adequacy and risk management norms.
 - India is implementing Basel III (focus on higher capital + liquidity buffers).

Digital Banking & Fintech Push

- CBDC (Digital Rupee):
 - Central Bank Digital Currency issued by RBI – both for wholesale and retail use.
- NARCL (Bad Bank):
 - National Asset Reconstruction Company – handles stressed assets of banks.
- Account Aggregator Framework:
 - Consent-based data sharing to promote financial data interoperability.
- Digital Banking Units (DBUs):
 - 75 DBUs launched across districts to promote paperless banking.

What is Money Supply?

- Money Supply refers to the total stock of money circulating in an economy at a particular point in time.
- It includes currency in circulation and deposits held by the public with commercial banks.
"The total amount of money people and businesses can use to spend or invest."

Why is it Important?

- It directly influences:
 - Inflation
 - Interest rates
 - Economic growth
- RBI monitors and controls money supply to maintain price stability and promote growth.

Measures of Money Supply in India (as per RBI)

RBI classifies the money supply into four categories – M1 to M4:

M1 (Narrow Money)

M1 =

1. Currency with the public (notes + coins)
 2. Demand deposits with banks (savings & current accounts)
 3. Other deposits with RBI
- Most liquid form of money
 - Used for day-to-day transactions

M2

M2 = M1 + Savings deposits with Post Office (excluding time deposits)

- Broader than M1
- Not used for daily transactions but still easily accessible

M3 (Broad Money)

M3 = M1 + Time deposits with commercial banks (like Fixed Deposits, Recurring Deposits)

- This is the most commonly used measure of money supply by RBI
- Reflects money available for lending and investment

M4

M4 = M3 + Total deposits with Post Office savings banks (including time deposits)

- Broadest measure of money supply
- Includes everything in M3 and all Post Office savings

Q1. The monetary policy as pursued by the Reserve Bank of India, can be aptly summed up in the phrase:

[OPSC OCS 2006]

Options:

- (a) Controlled monetary expansion
- (b) Cheap money
- (c) Dear money
- (d) Neutral money

Correct Answer: (a) Controlled monetary expansion

Explanation:

- RBI's monetary policy is designed to balance economic growth with inflation control.
- It aims to expand the money supply in the economy at a pace that does not fuel excessive inflation.
- This is referred to as controlled monetary expansion – not too much liquidity to cause inflation, but not too little to restrict growth.
- This policy ensures price stability, credit availability, and sustainable development.

Q2. In discharging its role as a facilitator for rural prosperity, NABARD is entrusted with responsibilities of:

[OPSC OCS 2022]

Options:

- (a) Providing refinance to lending institutions in rural areas
- (b) Promoting development of commercial banks
- (c) Monitoring and inspecting all banks in rural areas
- (d) Monitoring all developmental projects in rural areas

Correct Answer: (a) Providing refinance to lending institutions in rural areas

Explanation:

- NABARD (National Bank for Agriculture and Rural Development) was established in 1982.
- It acts as a refinancing institution, providing credit to cooperative banks, RRBs, and other rural financial institutions.

- NABARD does not directly lend to farmers but refines loans given by rural lending institutions.
- It plays a key role in promoting agriculture and rural infrastructure.

Q3. Out of the four concepts of money supply used in India, Post Office savings are included in:

[OPSC OCS 2021]

Options:

- (a) M1 only
- (b) M3 and M4 only
- (c) M4 only
- (d) M2 and M4 only

Correct Answer: (d) M2 and M4 only

Explanation:

India follows four measures of money supply:

- $M1 = \text{Currency with public} + \text{Demand deposits (bank)} + \text{Other deposits with RBI}$
- $M2 = M1 + \text{Post Office savings (excluding time deposits)}$
- $M3 = M1 + \text{Time deposits with banks}$
- $M4 = M3 + \text{Total Post Office savings (including time deposits)}$

Post Office savings are not part of M1 or M3, but included in M2 and M4, making (d) the correct option.

Q4. Consider the following statements in respect of Incremental Model of Policy Formulation:

[OPSC OCS 2021]

- (i) The concept of incrementalism in policy formulation is put forward by Robert Dahl.
- (ii) The disjointed policy making depicts policy making as a process of muddling through.
- (iii) The synoptic model acknowledges man's limited problem-solving capacities.
- (iv) Disjointed incrementalism explains governmental decision making.
- (v) Logical incrementalism explains strategy formulation in large organizations.

Choose the correct statements:

- (a) (i), (ii), and (iii)
- (b) (ii), (iii), and (v)
- (c) (ii), (iv), and (v)
- (d) (iii), (iv), and (v)

Correct Answer: (c) (ii), (iv), and (v)

Explanation:

- The Incremental Model was popularized by Charles E. Lindblom, not Robert Dahl (so statement i is wrong).
- It sees policymaking as gradual adjustments, not sweeping reforms.
- Disjointed Incrementalism refers to small, uncoordinated steps (called "muddling through") in government decision-making.
- Logical Incrementalism is used in business strategy, where organizations plan step-by-step to reduce uncertainty.
- The Synoptic model assumes rational decision-making with full data – the opposite of incrementalism.

Q5. The base year for Wholesale Price Index (WPI) has shifted to _____ from 2004–05:

[OPSC OCS 2021]

Options:

- (a) 2017–18
- (b) 2016–17
- (c) 2011–12
- (d) 2013–14

Correct Answer: (c) 2011–12

Explanation:

- WPI measures the average change in prices of wholesale-level goods.
- It's published by the Office of Economic Adviser, Ministry of Commerce.
- The base year for WPI was updated to 2011–12 in 2017, replacing 2004–05, to better reflect current consumption and production patterns.
- Items like smartphones, LED TVs, and new services were included in the updated WPI basket.

Q6. FRMBA is the act relating to:

[OPSC OCS 2011]

Options:

- (a) Fiscal Deficit
- (b) Revenue Deficit
- (c) Primary Deficit
- (d) Budgetary Deficit

Correct Answer: (a) Fiscal Deficit

Explanation:

- FRBM Act (2003) stands for Fiscal Responsibility and Budget Management Act.
- It sets fiscal discipline targets for the Central Government:
 - Reduce fiscal deficit
 - Eliminate revenue deficit
- Objective: To ensure macroeconomic stability, reduce debt burden, and make fiscal policy transparent.
- It was amended in 2018 with a new focus on Debt-to-GDP ratio and creating an independent Fiscal Council (yet to be set up).

Q7. The reserve held by commercial banks over and above the statutory minimum with the RBI are called:

[OPSC OCS 2020]

Options:

- (a) Cash Reserve
- (b) Deposit Reserve
- (c) Monetary Reserve
- (d) Excess Reserve

Correct Answer: (d) Excess Reserve

Explanation:

- Banks are required to maintain a certain minimum Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).
- If banks keep more reserves than the mandatory requirement, these are called Excess Reserves.
- They serve as buffer liquidity, especially in uncertain times.

- Excess reserves can be used to:
 - Meet sudden demand for cash
 - Avoid penalties
 - Lend in call money market

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