Money and Banking
Dr. Surajit Sinha
Department of Humanities and Social Sciences
Indian Institute of Technology, Kanpur

Lecture - 31

So, let us begin start. Now, we are with non-traditional functions of our central bank. It is not necessarily to that countries, other countries also have this kind of a setup. And we are with kind of a end of the non-traditional functions. We were talking about other credit control methods. And the first one I took up, which I often refer to, which you may have also heard. This is called statutory liquidity ratio; only doubt I have about is whether it is being maintained on a weekly basis or 4, 3 or I think 4, 9, 3. And SLR is quite different from CRR that you have also noticed, CRR, SLR it has many things in it.

So, I talked about that too and upper limit of SLR and we did reach upper limit of SLR around 1990s about 38.5, nearly upper limit 40 percent 38.5 in 1990 SLR, having said that. Now, I will go to something, which use to be very important when we use to use not to important any more, among under other credit control methods and this is called SCC. SCC

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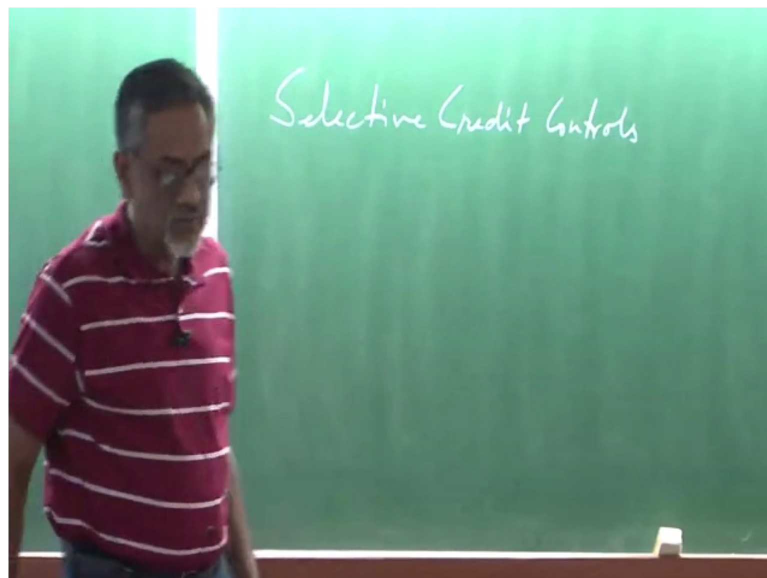

SCC is selective credit controls, now selective credit controls are available in India with the central bank. May be they are with some countries and if you notice what they are it

is a very country specific it has to be because selective credit controls are very much determent by the type of economy one country has. In India what kind of economy we have? If you look at that you went through my first course huge agricultural land, agriculture sector in terms of contradiction to GDP it is shrinking, but that doesn't mean that is minus sector.

Agriculture sector huge if you take points is number of people would depend up on agriculture for lively hood. It is massive over 60 percent people still depend up on agriculture in India. So, from that point of view agriculture is very important, and you also have notorious urban or semi urban economies where, hooding has been rampant what is hooding? Whole sellers of an practice that what they do is suppose, they pick an essential item like vanaspati or some other cooking oil, there should be that I remember sugar, which is to be not abundantly available in the open market, they take that they hood. Hood means create an artificial shortage in the economy, what you do like creating an artificial shortage?

In terms of demand supply you should the supply curve back words, so the price is go up. Once the price is go up sufficiently they release the stocks, slowly in to the market and make extra profit. So, hooding has been rampant, in modern economy India a different kind of the kind of a underground, or whatever not underground activity depend on a illegal activity that goes on, is that which we had cases here since 1919s. Before that they was on case in 1960s major case, small cases may be there.

One incident was there, there were some speculators in the stock market, artificial creates a rising price of stocks through kind of a hooding or whatever to make extra profit, fools the stock market there you require a huge amount of cash. In hooding of essential goods also you require huge amount of cash because you need to buy out the entire surrounding areas, from wherever supply comes and hood them. You have to plug all the supply routes to create an artificial shortage.

And that requires a huge amount of capital, money capital to buy outs the goods from other producers, or producers and sellers, whole sellers and create that shortage, or you can collude without all whole sellers or some major whole sellers together like drug cartels or opec oil prices they collude from a cartel, and act like a monopoly and there is

a prices create supply shortages in the market. Stock market hooding also speculative activity similar kind of things happened, and their bank managers extra all get involved.

Now, selective credit control if you look at selective credit controls where Indian economy is has to selective credit controls. Is that they were basically motivated by the seasonal nature of our agriculture early days 60, 70s agriculture was more important. Now, the service sector is developing, so some employment is going there. The industry sector at the manufacturing sector, secondary sector share may be going down by the service sector is taking up, taking over employment generation in India primarily.

And the jobs you will get, jobs you will get will probably 99 percent will be in the service sector. 99 percent any other engineering department jobs are there these days not in manufacturing just because I am a mechanical engineer or something. So, the seasonal mutual economic activities, where there is a sowing season then there is an hardware season there is a gap. In both the seasons you require fresh money to be available liquidity to be available, credit to be available.

And now if credit is not available during hardware season, or there is credit available with very dishonest hooders. They can choke of the fresh supply from the going in to the market and create the scarcity at the harvest season for instant sugar, rice, wheat whatever. So, hooding and inflation, which has been a major problem in India they all are connected and therefore. So, Reserve Bank from time to time would issue guidelines to banks, commercial banks regarding selective credit controls.

And they are just of the agriculture commodities they are also sometimes with respect to as I told you. They have been notorious cases, share market speculation that they have been holding. And artificial raising prices to make extra profit. So, the commercial banks and to some extent co-operative banks are primarily involved with RBI in choking out plans regarding credit supply. Now, what kind of a guidelines use to come? This is to be three kinds of broadly speaking selective credit control guidelines. That use to become as instructions from RBI to the commercial banks for specific time periods like 2 months, 1 month, 15 days whatever. What are they, they form the took are the following, number one.

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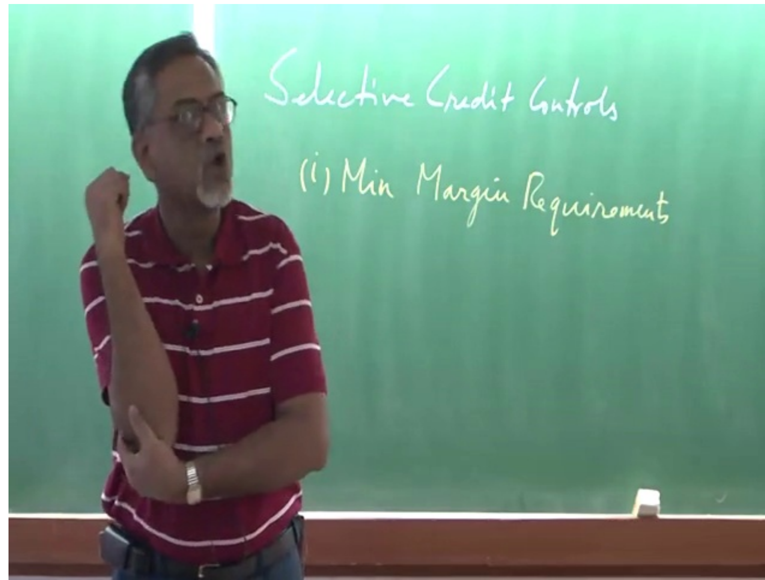

Minimum margin requirements this is one kind of a guideline that use to come. Now, it can be various margin requirements commodity specific, it may be commodity specific, it may be sector specific, it may also be producers specific even because some old orders are is also very well known to the community that they hold. So, it can be very specific company, specific to company of individuals, what is the meaning of margin requirement? That I need to explain. What happens at the time of sanction of loan by commercial banks to a company, when you, when it applies for a loan.

Company of course, has to submit all sources of documents regarding its functioning, financial statement or whatever balance sheets, professional loss accounts results, last 5 years balance sheet may be. They also have to show some submit some collateral securities. That collateral can be a various kinds, the collateral can be simply in terms of valuables like jewelry or land or property. Collateral can take various forms, but once the collateral is shown the security shown to the bank. Bank doesn't necessarily grant a loan equal in value at current market prices, at current market prices equivalent in value to the collateral it doesn't.

Suppose, the collateral is worth 10 cores, the bank may not sanction 10 cores. Bank will have margin requirement, it will deduct 15, 20, 25 percent of that value and then whatever remains from the collateral current market price value, they will decide how much loan to give to a particular party. So, suppose you have a property worth 1 core and

you show that property at current market prices to that bank, or with all your documents legal documents deeds extra. I say this is my collateral give me a loan for this purpose I need. Bank may not give you 1 core of loan, it equally doesn't there is a margin requirement some amount is chopped off from that current market price value of the collateral. And then whatever remains, the loan is in proportion to the remaining value of the collateral. So, the margin requirement therefore, is a powerful instrument as a selective credit control method, in the hands of the bank to control the amount of money it can release.

For instance in case of farmers, poor formers during sowing season RBI may issue a guideline, the margin requirement be cut down to nearly 0 or 5 percent. Whatever collateral they show because they are very poor formers, but in case of a hooder it may increase the margin requirement during harvest season, which are notorious borrowers they know, they would come and borrow legally. They may increase a collateral from 25 to 40 percent, 50 percent the margin requirement. That means 45, 25 to 40 percent is 40 percent of the collateral has to be deducted, then the bank will think how much money it will give to that particular party.

So, it can work both ways to tighten dishonest borrowers from getting too much they already accumulated wealth. So, they can't show collateral very easily and loosen to help out, the poorer section of the society like formers whether margin requirements have become they can make it minimum. You understand what I am saying, during harvest season, sowing season etc, and share market investments, so that they don't get.

Then you want so sir, if there are selective credit controls how did Harshad Mehta collide with the bank managers. Well these are all ignoring these rules often violating the norms they do in India it is always possible. Now, once you are caught you are caught often you are not caught. Harshad Mehta at least had 10 to 20 bank managers in their pocket. Where did you get the cash to control the stock market or whatever, stock market price hit because huge amount of cash? How did you get it has to come from somewhere it can from banks again.

So, speculative activities in the share market and speculative activities in the goods market. Particularly food items having very common and selective credit controls, in terms of this instrument use to be very common popular in India. RBI would issue those

guidelines. Second there and they can specify minimum lending rates also, when the banks are giving loans banks during sowing season.

The loans that you will give to the formers will have less than your normal rates is the normal rate is of 12 percent make it 6 percent, may be 7 percent, may be 5 percent minimum lending rates they can specify that's why these control banks. That's why we never had a free interest rate resume in India bank interest rates in a bound controlled. So, the next point is the lending rates.

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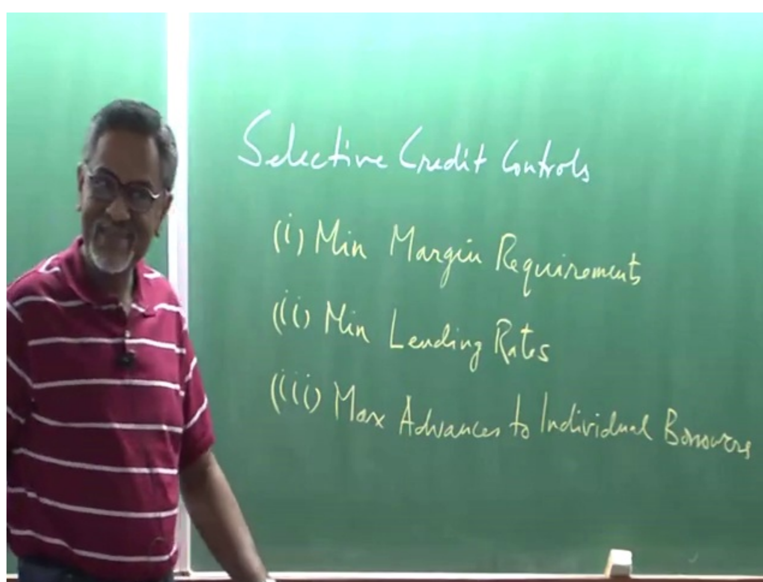

Minimum lending rates this is another instrument that they would use and differentiate in rates also. If it is for this purpose is the minimum rate for another case, it may be whole seller buying goods from the producer rates are very high. Farmers going for buying fertilizer seed etc rates are very low there are differentiated rates. And then you set for specific time periods for specific sectors, for specific borrowers, groups of borrowers RBI use to control that.

Third point is the very important this is the respect to these hooders, black marketers which we also call them, which we also call them black market is hooders in food items particularly, who create artificial shortages in the market and raise prices. Third instrument and the selective credit control commonly used in India; the third item maximum advances to individual borrowers.

Maximum advances to individual borrowers they can as I was telling you, often they have information like a police department, which are the guides, which are the companies responsive for hooding. Say, in vanaspati they know the whole sellers that use to be the case sugar they know. So, RBI would simply put a limit on the, upper limit on the advances they can get particularly during those season when they would hold. In other months probably they are very seasonal in nature.

Selective credit control has been very seasonal in nature, they are not often there, the restrictions are often not there throughout the year all 12 months. They are therefore 2 months again a gap, again for 2 months may be or 1 month, two-forth, three-forth nights or whatever and then off they would go. So, this is the three main rules they use to take. And selective credit control rates I have told you, but then what happened I have a data from 1971-72 or 72-73.

Let me tell you about the SCC minimum rate, lending rates what they did particularly for these hooders etc. When it is 10 to 11 percent, the general rate in 73 – 74; when I was in getting in to college and stuff like that I remember I should study this things very boring money and bringing course any way. Then the typical it was 1 or 2 percentage point less than that for not to 1 or 2 percentage much higher than the market rate.

So, you need money from the bank then, but you know there are also revenues as they will get that. And then in 1970 and 80 you don't believe me the minimum lending rate of a selective credit control became ranged between 15 to 18 when the general minimum rate was 12.5 percent. And then 80 - 81, 16.7 to 19.5 where as the general rate in India was 13.5. So, if the gap is big, 4 - 5 percent gap means on a loan that you are taking in lakhs or crores of rupees huge amount of extra interest that you have to pay, huge massive amount of interest you have to pay. So, this is all it use to work, but unfortunately I still remember the general lending rate was very less than the rate they ask me on my educational loan around 1980s.

So, did you think that these students are go for higher studies or whatever take loan from banks, should come under the selective credit control measures of RBI. They would go and they will come back and do hooding or illegal business. You won't believe me, rates were very high educational loan rates. It is very interesting educational loan those days, now it is changed probably is still more expensive than the companies borrowing money

from banks. India is a very funny country. I really don't understand all this to you. You may understand this, I mean pay high I paid an interest rate about 18 percent or 17 percent on the loan that I took.

Now, I come to this section, which is very important, so I will begin this section I may not end it today because it's already 2:26. This started from the end of the last century and became important in the beginning of this century. This is credit control through a policy of the government of India initially and then it is RBI policy. RBI operates that and this is where the repo market I talked about RBI is repo market, this is the thing today we started in the end of last century, and took shape proper, shape in the beginning of this century, under which RBI operates the repo market. There is one repo market in the bank, which is market repo on, which I have no data very interesting.

Central bank doesn't care to collect data on the market repo. Only repo data they supply on their site if you go from where I access data is the one, which which is under this policy. This is called this is I am coming to the end of this topic nearly next week it will end. Then I will show you data and most probably after break, most probably the last topic will begin. So, very important topic banks, I will talk about this is called the thing I need to talk about, now is called.

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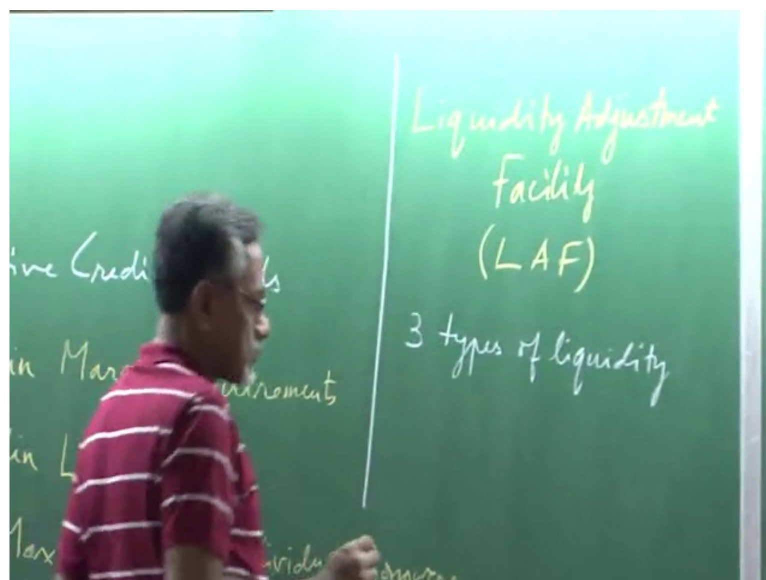

Liquidity adjustment facility called the famous LAF. So, when I supply data on repo market it is the RBIs LAF data, under LAF this umbrella they operate the repo market.

And this has come to be known the most important short term money market and the interest rate also. This is LAF liquidity adjustment facility, what is the basic concept? According to these banking industry, or central bank they have conceptual, conceptually they have or they consider or they deal with three kinds of liquidity. They deal with three kinds of liquidity or three types of liquidity.

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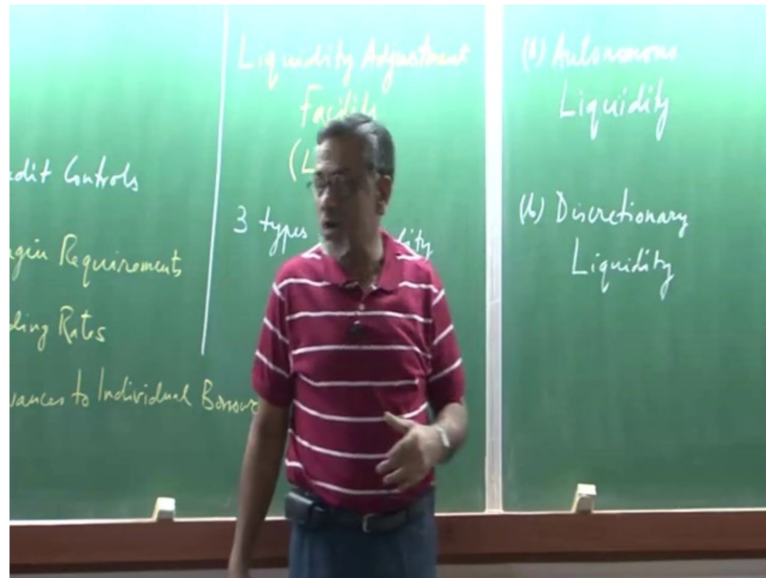

Three types of liquidity, the first one is known as a known as autonomous liquidity, this is known as autonomous liquidity. Three types of liquidity they deal with liquidity adjustment facility is called autonomous liquidity. What is autonomous liquidity? Autonomous liquidity that is the liquidity that kind of gets created from the normal operations, banking operations of the central bank as a currency authority and banker to the government.

So, for the normal operations of the central bank as you have learned so for of or RBI central bank means RBI. What are they? To give the ways the means advances to government when they need, both state governments and central government. Then they subscribe to the treasury bills, and government securities early they use to have also adapt treasury bills the money market section. And then they also have the cash, the currency that the issue from time to time. Say the exporter has come submits the foreign dollar, foreign exchange gets it converted in to rupee. The issue department and the banking department I was talking about.

So, these are the normal operations of the economy and the balance sheet of RBI would tell you that these are the money that RBI creates or liquidity. Liquidity is essentially the cash that it injects in to the system. This is as a currency authority and banker to the government and often also probably as a banker to the banks because often submit the bills that they hold, and re-discount them with the central bank and get the cash in return. This is autonomous liquidity then you have the other kind of liquidity that the central bank of India that is RBI manages is called the discretionary liquidity.

Discretionary liquidity this is not normal discretionary liquidity is something, which RBI creates a deals with because a monetary policy that talks. So, suppose it opts for there is too much of liquidity it has to sell repo that is discretionarily management of liquidity, or management of discretionary liquidity. Now, I consciously and also action of repo or whatever reverse repo to counter this excessive or defficial liquidity situation in the martri sector like repo sells. This is discretionary liquidity and it can also be just not repo sells it can also be open market operations with government dated securities.

RBI decides like they have recently they did, they would go for open market sale of security, so that the liquidity squeezed out of the system. Now, it is going for an expansionary monetary policy, what do you mean expansionary monetary policy? In economics it is known as LM shift. How does it happen? From one be it can happen is by open market purchase of securities, where cash is injected in to the system LM curve would shift to the right open market operations.

These are conscious effort from time to time as part of something called monetary policy of the central bank, which they adapt. They decide and act like vitamin in take that you have is through a normal of normal course of life we are existing is through food, but now there is deficiency of vitamin in your system. Then I artificial inject vitamin that is the discretionary liquidity the normal food in take whatever vitamin you are consuming. Hopefully you are consuming from your hostel food is the autonomous liquidity, or you are wondering whether you consume that at all. You should inform your parents we are not getting any vitamin, you should get discretionary in doses of vitamin send to us in parcels.

So, that we can have them otherwise exam either may (( )). So, autonomous liquidity and discretionary liquidity these are kind of two things. This is the normal process of

working of the economy government needs this money. This is the money export coming in import etc creating it and this discretion is like open market operation, the repo market of the RBI etc, creates that. The market repo will be part of the autonomous liquidity of the entire system. Now, if you add this up whether liquidity as increased or decreased.

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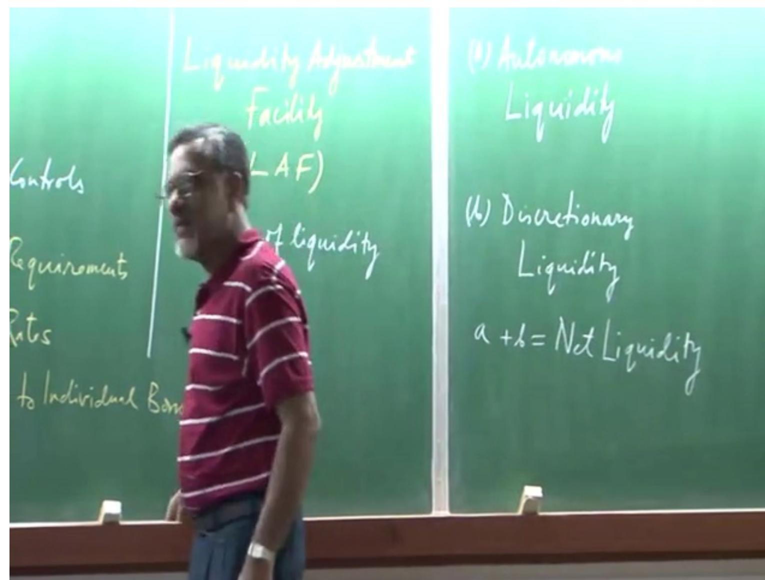

Addition of a and b gives you something called what they call net liquidity. So, this is something which they have in mind RBI, when it talks about thinks about liquidity. Now, the problem is that this is where I have been telling this bloody here who is trying to, now getting to a (( )) page decreases. I mean trying to tell that this liquidity is a thing, which RBI control set as monetary policy at quarter head office, header of all this institutions with respect to banks monthly. Say, CRR controlling liquidity with respect to banks because bank's deposits are held as CRR or SLR, but with financial innovation and sophisticated of the economy there are, so many non banks out there. How does RBI control their liquidity?

There is no CRR, there is no SLR, but monetary policy should have some significance of relevance for them as well because you are trying to control the none, you are trying to control the bank liquidity. Suppose, you want restrict liquidity, you are trying to controller it, reduce it to contraction policy with respect to banks, but the non banks (( )) or non banking set a share in money market is also increasing. This is where RBI has a

bigger headache. This is exactly where the financial system also got in to trouble in the western bond.

There are not only bank failures and no CRR etc, which they should have add to bail of the banks it fell on a government, but a large number of know banks started faltering. Housing banks, what are the names Morgan Stanley was in trouble then that famous housing market creditor in U S Ley Man Brothers, not city bank commercial bank where in trouble.

The non banks housing market they deal with in the what’s the name (( )) this is a non bank, non bank was fine doing and this the one of the problem the regulatory mechanisms. Normally in a monetary system through central bank on the banks, but what’s about non banks. So, this is a big problem. So, as this as become very difficult, but there what they are doing is that they are trying to the repo market this we need to find out how much they are trying to influence the banking sector in particular, but may be some non banks are also I really don’t know.

What is the name of that? Housing hosing sector famous us (( )). I will give you the name

Funny and funny.

Yes, yes what they did was is essentially they inserted the credit system, so much by giving out loans then a loans didn’t return come back. And then they get in to for sale of properties overnight whatever value you get and they couldn’t recover the dept. Funny and something.

Funny and Fredy,.

Funny Fredy kinds of names are there is very funny Funny, Fredy or whatever. Now, this is exactly where they got in to trouble non banks also just not banks because the non banks happily giving out loans, thinking lot of business they are doing all work around credit system. What kind a credit system? You are base is this much, you are creating credit worth this much. If you mismanage it the equations, the numbers you can be in big trouble.

And then money, which you are expecting to come in to give out the money to the others, and also give the interest and depositors etc, get in who is going to help them nobody is there to help them. So, you declare lockout or whatever liquidation or something like that bankruptcy, you declare bankruptcy (( )). The entire system is depended upon them got in to trouble all these borrowers, all the depositors, whatever they did they had public money also with them.

So, there was a famous banking committee in India, Narasimham committee - 2 to look in to this liquidity management at the end of last century to recommend banking sector reforms that's where LAF came Narasimham committee - 2. There was an Narasimham committee -1 earlier I remember, I read it the committee 2. Essentially they wanted to find out how they can manage short term funds liquidity in the system RBI can manage them. And how they can also provide in a growing economy where the reforms is already started end of last century I am talking about.

So, 1990s decades end, how sufficient liquidity can be made available because economy is, now growing and company is need cash, more investment banks need to provide the banks just for survive (( )), which has to get I should can buy something sorry (( )). You won't believe me, this were the stories when I was growing up you going to buy something sorry we don't have it.

Now, you don't get it you have a sense, so much unbelievable you go and try to buy sugar shop is not available bloody. And sugar through ration shop my goodness, you will have only the, only cup of tea in your life probably with that sugar. You will not attend the second cup it was so dirty full of all those things in the sugar not sugar you know whatever, you can be in big trouble. So, based on Narasimham committee report on banking reforms end of last century, in April 1999 this date you should remember, April 1999.

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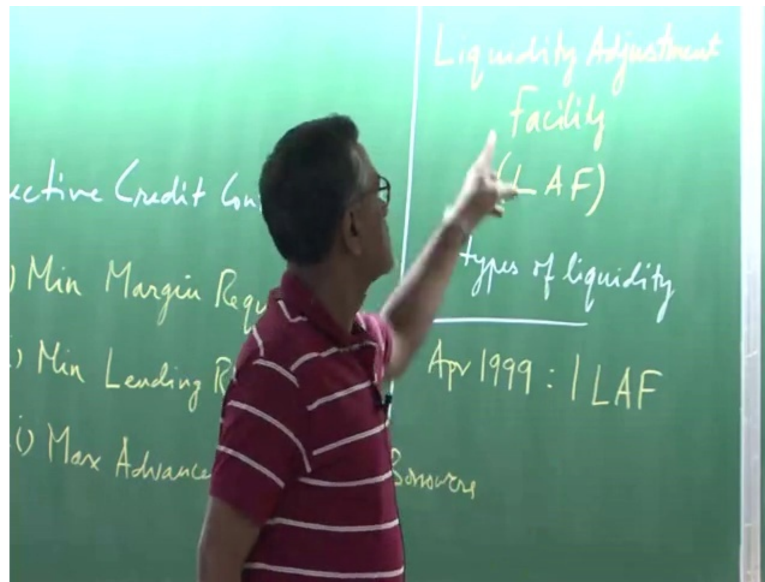

They floated something called April 1999, they floated something called ILAF. ILAF a program they floated RBIs program to control liquidity. There is it’s called interim liquidity adjustment facility, interim interim liquidity adjustment facility. Now, how would they do this liquidity adjustment and they would try out for a few months, or year or so. And if would works alright then they would for float what we have now for many years now 10 - 12 years LAF. If you open RBI site they will tell you immediately a repo data open (( )) this repo transactions are under LAF.

So, interim liquidity adjustment facility they would be operate on a trial basis. Like you have develop a prototype will going to get a run of the prototype for a few months before you finally, announce the product in the market on a commercial sale basis or something, which often happens with many, many products engineering products. So, this is an financial product a package is essentially a package of basket of things that RBI introduced or used to control liquidity in the system call ILAF, which has few items in it ILF.

ILAF has few items in it, so ILF essentially is taking about the discretionary liquidity to control the total liquidity they would like to have. The net liquidity can be the target liquidity. So, they would try to control it and this one they have very little control for they are saying an autonomous liquidity it is the normal working of economy. So, normal

individual thing I mean how control body temperature and everything if there is some (( )) then you try to adjust that.

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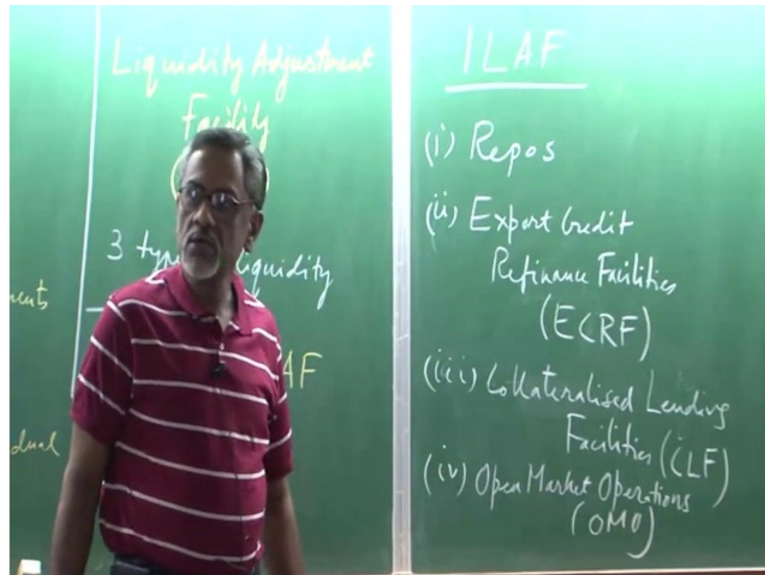

So, to control the discretionary part or to operate the discretionary part ILAF, ILAF as a basket of things, first what they set or my notes are saying they would have repos; they would use repos to do that. Two what will they do, two they would use export credit refinance facilities, export credit refinance facilities known as ECRF. Export credit refinance facilities, so they would after wide banks because they just open the export market.

Remember my notes go back to a wide last course that you credited, industry sector we did opened they are few areas, where they went for reforms. And the export sector is on the major sectors they went for reforms and I have to investment export etc. So, export credit refinance facilities banks are giving export credit to exporters. And RBI is going to have a line of export credit for the banks to use the money to refinance export credit to exporters.

Like you and you and you are exporting are you use bank money to do your business. If you suddenly stops your business will get affected, and India is trying to be careful about it. The same thing use to happen with Nabard, RBI use to get funds Nabard is to use that for agriculture credit slowly Nabard become independent. So, now banks require extra funds to support the export sector. So, RBI is going to give the money to banks and

banks are going to use that, but there is a system through, which will work I would explain the system later. Export credit refinance facilities is ECRF, then they have collateralized lending facilities, another thing they had collateralized lending facilities called CLF.

Collateralized lending facilities called CLF and of course, they would have open market operations, final open market operations OMO, open market operations OMO. So, is this all yes, so they are the basket or the instruments. That they would use to control discretional liquidity to manage in order to manage the liquidity in the monetary system in the economy. Under the scheme called ILF in April 1999 they floated it this was the Narasimham committee on banking reforms also committee two on banking reforms.

I read Narasimham committee 1 reports many years back, I heard about it I had references to that. This is second Narasimham committee - 2 on banking reforms because you to recall from your last course either course with me last course with me, there was an Indian economy course I was talking about how in 1991, these structure reforms were initiated by Dr. Manmohan Singh and team. And therefore, it changed many things in India economy and they were very conscious about it there was a banking sector reforms committee setup by RBI, I think government of India. I think RBI, which is not on common in India, RBI did setup from time to time various working groups and various committees tooks provides suggestions advices as to what to be done.