Monetary and Credit Policy

Definitions:

- The strategy of influencing movements of the money supply and interest rates to affect output and inflation
- The actions of a central bank that determine the size and rate of growth of the money supply, which in turn affects interest rates.
- A macroeconomic policy tool used to influence interest rates, inflation, and credit availability through changes in the supply of money available in the economy
- An attempt to achieve broad economic goals by the regulation of the supply of money
- The regulation of the money supply and interest rates by a central bank in order to control inflation and stabilise currency
- Monetary policy is the process of managing a nation's money supply to achieve specific goals—such as constraining inflation, achieving full employment etc.
- Monetary policy is made by the central bank to manage money supply to achieve specific goals—such as constraining inflation, maintaining an appropriate exchange rate, generating jobs and economic growth. Monetary policy involves changing interest rates, either directly or indirectly through open market operations, setting reserve requirements, or trading in foreign exchange markets.

Monetary Policy

The use by the Central Bank of interest rate and other instruments to influence money supply to achieve certain macro economic goals is known as monetary policy. Credit policy is a part of monetary policy as it deals with how much and at what rate credit is advanced by the banks. Objectives of monetary policy are:

- accelerating growth of economy
- price stability
- exchange rate stabilization
- balancing savings and investment
- Generating employment and

Monetary policy can be expansionary or contractionary : expansionary policy increases the total supply of money in the economy as in 2008-09 all over the world including India to beat recession/slowdown; and a contractionary policy decreases the total money supply by tightening credit conditions(2010 onwards in India). Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to control inflation.

Historically, Monetary Policy was announced twice a year - a slack season policy (April-September) and a busy season policy (October-March) in accordance with agricultural cycles. Initially, the Reserve Bank of India announced all its monetary measures twice a year in the Monetary and Credit Policy. However, since monetary Policy has become dynamic in nature, RBI reserves its right to alter it from time to time, depending on the state of the economy. Also, with the share of credit to agriculture coming down and credit towards the industry being granted whole year around, the RBI since 1998-99 has been making the policy in April. A review of the policy takes place every quarter. Within the quarter at any time, there can be changes- major and minor, depending on the need.

The tools available for the central bank to achieve the monetary policy ends are the following

- Bank rate
- Reserve ratios
- Open market operations
- Intervention in the forex market and
- Moral suasion

Bank rate

Bank Rate is the rate at which RBI lends long term to commercial banks. Bank Rate is a tool which RBI uses for managing money supply. Any revision in Bank Rate by RBI is a signal to banks to revise deposit rates as well as prime lending rate (PLR is the rate at which banks lend to the best customers. It is not in use any more.) Bank rate is in a limbo. It has no effective use. It is a penal rate. In 2011, the bank rate was aligned with the newly introduced marginal standing facility. Today it stands at 9 %(2012).Bank Rate is aligned with Marginal Standing Facility (MSF) rate, which, in turn, is linked to the policy repo rate. Alignment was because the MSF is also a penal rate. (Read ahead) . Bank rate has been replaced with repo rate as the policy rate for many years now. The Bank Rate acts as the penal rate charged on banks for shortfalls in meeting their reserve requirements (cash reserve ratio and statutory liquidity ratio). Read ahead.

Ready Forward Contracts (Repos)

It is a transaction in which two parties agree to sell and repurchase the same security. Under such an agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and a price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date in future at a predetermined price.

In India, RBI lends on a short term basis to banks on the security of the government bonds (repo) . Banks undertake to repurchase the security at a later date- over night or few days. RBI charges a repo rate for the money it lends. It is 7.75 % presently (2013 October)

Reverse repo is when RBI borrows from the market (absorbs excess liquidity) on the basis of securities and repurchases them the next day or after a few days. The rate at which it borrows is called reverse repo rate as it is the reverse of the repo operation. Reverse repo rate 100% basis points (1%) below the repo rate.

The Repo/Reverse Repo transaction can only be done at Mumbai and in securities as approved by RBI (Treasury Bills, Central/State Govt securities). RBI uses Repo and Reverse repo as instruments for liquidity adjustment in the system.

Repo rate is known as policy rate and is used as signal to the financial system to adjust their lending and borrowing operations.

MSF

In 2011, RBI introduced the Marginal Standing Facility as a window through which the commercial banks can borrow from the RBI at a rate that is 1% more than the repo rate. It is meant to ease liquidity in the market. Banks can use the repo route for the securities over and above the mandatory SLR holdings- 23% of bank deposits. MSF is open to the banks that want to borrow from the RBI even if the credit is costlier by a percentage point. Totally, 2 % of the value of deposits is the limit for the MSF window for each bank. The aim is ease liquidity.

MSF is the penal rate- because the repo limit is exhausted and also because the SLR limit is breached. Bank rate is also a penal rate- for breaching the SLR and CRR limits. Therefore, there is a need to bring the bank rate on par with the MSF as was done by the RBI in 2011-12. Both stand at 8.75% today(2013 October). Thus, the gap between the Repo rate and the MSF which as a norm has to be 1% has been restored as it was widely breached in 2013 July when the MSF was kept at 3% above the Repo rate which was a policy initiative by the RBI to stem speculation on the rupee. Since relative normalcy returned on the rupee front, MSF came back to normative levels.

MSF window also has become necessary because the repo operations are limited to a specific period during the day.

Banks can borrow under MSF in lieu of whatever excessive SLR they have. There is no limit here. If a bank has overshot SLR limits to 28% and needs funds, it can borrow from RBI funds worth 5% (of its NDTL).

What if a bank does not have excess SLR? Can it borrow? Yes it can. Currently RBI allows banks to borrow 2% of NDTL below SLR under MSF and and funds worth 0.5% of NDTL for providing assistance to Mutual Funds. So, say a bank has 23% SLR; it can borrow funds under MSF worth 2%. When MSF became a policy measure in May-11, banks were only given the second option of borrowing in case it does not have an excess SLR. The limit was 1%. In Dec-11, Banks were given the excess SLR choice.

LAF

Liquidity Adjustment Facility (LAF) was introduced by RBI in 2000. Funds under LAF are used by the banks for their day-to-day mismatches in liquidity. LAF covers credit at repo and reverse repo rates.

Reserve Requirements

In economics, fractional-reserve banking is the near-universal practice of banks in which banks keep a fraction of the total deposits managed by a bank as reserves that are not to be lent. The reserve ratios are periodically changed by the RBI. The reserve requirement is a bank regulation, that sets the minimum reserves each bank must hold as a part of the deposits. These reserves are designed to satisfy various needs like providing loans to the Government(SLR), safety of banking operations, regulation of liquidity, management of interest rates, checking speculation and inflation management(CRR).They are in the form of RBI approved securities (SLR) kept with themselves or cash that is kept with the RBI(CRR).

Statutory liquidity ratio (SLR)

It is the portion of time(fixed deposits) and demand liabilities(savings bank and current accounts) of banks that they should keep in the form of designated liquid assets like government securities and other RBI-approved securities like public sector bonds ; current account balances with other banks and gold .SLR aims at ensuring that the need for government funds is partly but surely met by the banks. SLR was progressively brought down from 38.5% in 1991 to 23% (2012).

SLR is a blunt instrument and was unchanged for more than a decade and half till the Lehman-induced global financial and economic crisis of 2008.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on SLR at 25% and 40% respectively. But the amendment made in these statutes in 2007 removed the lower limit but retained the cap at 40%. RBI has, as a result, the freedom to reduce the SLR to any rate depending on the macro economic conditions. The amendment was an enabling one.

Reduction of SLR - means ready for investment from foreign

CRR

CRR is a monetary tool to regulate money supply. It is the portion of the bank deposits that a bank should keep with the RBI in cash form. CRR deposits earn no interest. The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on CRR at 3% and 20% respectively. But the amendment made in these statutes in 2007 removed the limits- lower and upper. RBI has, as a result, greater operational flexibility to make its monetary adjustments. CRR is adjusted to manage liquidity and inflation The more the CRR, the less the money available for lending by the banks to players in the economy. CRR was 15% in 1991 and today it is 4%(2013 October) twice . If inflation is high, money supply needs to be taken out and so CRR is generally increased. But in a regime of moderate inflation, low CRR is in place.

RBI increases CRR to tighten credit and lowers CRR to expand credit. During the downturn after the global Great Recession 2008 October onwards, CRR was reduced but as growth and inflation returned since 2009, CRR was gradually increased .

CRR as a tool of monetary policy is used when there is a relatively serious need to manage credit and inflation. Otherwise, normally, RBI relies on signaling its intent through the policy rates of repo and reverse repo . Based on these rates, RBI conducts open market operations for liquidity management.

Open Market Operations Of RBI

OMOs of the RBI can be described as outright purchase and sale of government securities in the open market (open market essentially means banks and financial institutions) by the RBI in order to influence the volume of money and credit in the economy. Purchase of government securities injects money into the market and thus expands credit; sales have the opposite effect- absorb excess liquidity and shrink credit. Open market operations are RBI's most important and flexible monetary policy tool. Open market operations do not change the total stock of government securities but change the proportion held by the RBI, commercial and cooperative banks.

Selective Credit Controls

Certain businesses can be given more and certain others may get less credit from banks on the orders of the RBI. Thus, selective credit controls can be imposed for meeting various goals like discouraging hoarding and black-marketing of certain essential commodities by traders etc by giving them less credit. Either credit can be rationed or interest rate can be hiked by RBI for certain sectors as a part of SCCs. In SCCs, the total quantum of credit does not change, but the amount lent and the cost of credit may be changed for specific sector or sectors.

Moral suasion

A persuasion measure used by Central bank to influence and pressure, but not force, banks into adhering to policy. Measures used are closed-door meetings with bank directors, increased severity of inspections, discussions, appeals to community spirit etc.

Recently the RBI Governor appealed to banks not to raise rates even though the central bank was following a tight money policy.

base effect -

Market Stabilization Bonds

In 2004, RBI floated Government securities, as a part of the Market Stabilization Scheme, to absorb excess liquidity from the market. The excess liquidity is the result of RBI buying dollars from the market. MSS is a sterilization effort of the central bank. The normally available government securities are not enough for the RBI to suck out the huge rupee supply (printed money called base money or reserve money or high powered money) that was caused for buying dollar. Therefore, the MSS was started.

Interest rates and their significance

Interest rates are the rates offered to money that is deposited in the banks; rates offered for investment in bonds; rates at which money is borrowed from banks and financial institutions -; and rates charged from the borrowers etc.

Savers want higher interest rate while investors want the cost of credit to be low. There has to be a balance. The determinants of interest rates are:

- Inflation- the higher the inflation, the higher the interest rates because the same money invested in commodities and other assets should not fetch more, because of the inflation:
- Need for growth :lower interest rates reduce cost of credit and facilitate investment for growth
- Promotion of savings
- Government's need to borrow: the magnitude of government's borrowing programme also determines interest rates. The more the borrowing, the higher the interest rates.
- Need to generate demand :as interest rates come down, consumer demand for credit goes up and there will be a stimulus for growth
- Global trends as we need to retain foreign funds. For example, interest rates on NRI deposits were increased in 2013 to attract their dollar deposits under the FCNR(B) swap window.(Given elsewhere)

Deregulation of Interest Rates

As a part of banking sector reforms, interest rates have been deregulated. The rationale is that banks can adjust rates quickly according to market conditions; financial innovations should be facilitated; competitive rates can be good for savers and investors; global alignment is possible more dynamically; etc. RBI however, uses repo rates and CRR adjustments to influence interest rates.

Since 2010, they are being hiked again as inflation is a worry- food inflation being even worse.

Soverign bond - bond issued by GOI to foreign investment
semi soverign - issued by govt. corporation with permission of

Floating and Flexible Rates of Interest

There are two types of interest rate- fixed and floating. If they are offered together (when they co exist), it is called flexible interest rate regime. Floating interest rates are linked to an underlying benchmark rate. In other words, the interest rate offered `floats' in relation to the interest rate of a government security instrument of similar maturity( 5 years or 10 years maturity etc) as determined by the market. That is, floating rates of interest are basically market driven rather than `fixed'. The effective rate is adjusted on a quarterly or semi-annually or annually.

Inflation targeting

Under this policy approach the target is to keep inflation in a particular range or at a particular level. Government and the RBI agree on convergence between the fiscal and the monetary policies to achieve the common goal. RBI is given autonomy to manage inflation while the government agrees to have a fiscal policy that will contribute to price stability- for example, not borrow excessively etc. India does not follow it.

This monetary policy approach was pioneered in New Zealand. It is currently used in the Eurozone, Australia, Canada, New Zealand, Sweden, South Africa, Norway and the United Kingdom.(See Chapter on Inflation for more)

Reserve Bank of India

The central bank of the country is the Reserve Bank of India (RBI). It was established in 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Reserve Bank of India was nationalised in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi

The Reserve Bank of India Act, 1934 came into effect in 1935. The Act provides the

Statutory basis of the functioning of the bank.

Reserve Bank of India Functions

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank to the reserve bank of India.

Bank of issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes.

RBI should maintain gold & foreign exchange reserves of Rs. 200 cr, of which Rs. 115 cr. should be in gold. However, the amount of currency that the RBI can print depends upon the need of the economy. The only restriction is the systemic one- it should not create instability with too much or too less of money supply. Money supply should have a correspondence to the goods in the economy and the rates of growth.

Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India. The Reserve Bank has the obligation to transact Government business, to receive and to make payments on behalf of the Government and to carry out their other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to raise loans . The Bank makes ways and means advances to the Governments. It acts as adviser to the Government on all monetary and banking matters.

Bankers Bank and lender of the last resort.

The Reserve Bank of India acts as the bankers' bank.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities by rediscounting bills of exchange. CRR deposits of banks are kept with the RBI.

Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crises, the Reserve Bank is the lender of the last resort.

Controller of credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the instruments available to it(see above). According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to Particular groups or persons.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank has to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a periodical return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

Agent and Adviser of the Government

The RBI acts, as the financial agent and adviser to the Government. It renders the following functions:

(a) As an agent to the Government, it accepts loans and manages public debts on behalf of the Government.

(b) It issues Government bonds, treasury bills, etc.

(c) Acts as the financial adviser to the Government in all important economic and financial matters.

Functions as National Clearing House

In India RBI acts as the clearing house for settlement of banking transactions. This function of clearing house enables the other banks to settle their interbank claims easily. Further it facilitates the settlement economically. It essentially means the inter-bank cheque clearing settlement.

The RBI acts as a lender of last resort or emergency fund provider to the other member banks. As such, if the commercial banks are not able to get financial assistance from any other sources, then as a last resort, they can approach the RBI for the necessary financial assistance.

In such situations, the RBI provides credit facilities to the commercial banks on eligible securities including genuine trade bills which are usually made available at repo Rate/MSF.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to act as the custodian of India's reserve of international currencies. It takes up operations in the forex market to stabilize the exchange rate of rupee and ensure that there is no speculation and there is order. To be able to do so effectively, it holds forex reserves which it acquires from the market(purchases). It has about 282 b of forex reserves (2013 October) which includes foreign currency assets, gold and IMF's SDRs). SDRs are increasing in importance since 2008 when dollar stability came under question. Diversification and hedging of risk is being done by all central banks. Even though rupee exchange rate is market driven, RBI watches the movement to ensure order and normalcy and there is no volatility. Thus, it maintains exchange rate oversight. Mid-2013 policy action of the RBI is ample proof that RBI will not allow excessive volatility in the rupee rate. It has many levers which we will discuss in the chapter ahead on BOP.

Supervisory functions

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, setting reserve ratios etc. They are:

- Granting license to banks.
- Inspect and make enquiry or determine position in respect of matters under various sections of RBI and Banking Regulation Act.
- Implementation of Deposit Insurance Scheme.
- Periodical review of the work of commercial banks.
- Giving directives to commercial banks.
- Control the non- banking finance corporations.
- Ensuring the health of financial system through on-site and off-site verifications.

More such functions are given to the RBI under the **Banking Laws (Amendment)** Act **2012.**

Promotional Functions

Since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; the Industrial Development Bank of India in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote savings, and to provide industrial finance as well as agricultural finance. NABARD was set up in 1982. It has an important role in facilitating microfinance for financial inclusion. Further, its innovations include banking correspondent model for rural banking.

Functions of central bank, in sum

- monopoly on the issue of banknotes
- the Government's banker
- bankers' bank
- Lender of Last Resort
- manages the country's foreign exchange and gold reserves
- regulation and supervision of the banking industry;
- setting the official interest rate - used to manage both inflation and the country's exchange rate.

Globle reserve currancy.

The central bank's main responsibility is the making of monetary policy to ensure a stable economy, including a stable currency. It aims to manage inflation (rising average prices) as well as deflation (falling prices). It is the lender of last resort, and assists banks in cases of financial distress (see also bank runs).

Furthermore, it holds foreign exchange reserves and official gold reserves, and has influence over exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float"). India falls in the market-determined category largely.

Typically a central bank controls certain types of short-term interest rates(repo and reverse repo rates) These influence the stock- and bond markets as well as mortgage and other interest rates.

RBI Act amended 2006

Government made amendments to RBI Act 1934 and Banking Regulation Act for allowing the apex bank to have more flexibility to fix the SLR and Cash Reserve Ratio (CRR). It removed the floor and cap on CRR and floor on statutory liquidity ratio (SLR) to provide flexibility to RBI to manage liquidity. This would result in better liquidity management in the system.

Debt management office DMO

In the late 1990's, a working group of the Reserve Bank of India first suggested the separation of its debt management and monetary policy functions of the central bank.

In keeping with global practices of the time, the group made out a case for separating the role of a bank in managing borrowings for the central and state governments, leaving the RBI to focus mainly on setting interest rates and price stability.

Although the government first announced its intention to form a new debt management office in 2007, there has been little progress. The move came appropriately at a time when the process of fiscal consolidation was well underway.

Economic growth was buoyant then and public deficit and debt indicators, too, were under control. But the Indian central bank did not appear to be fully convinced.

Since then, in the wake of the global financial crisis, there has been some rethink about the perceived benefits of a separation of public debt management from monetary policy, especially in the context of the poor state of national balance sheets.

Several committees, including the ones headed by Jehangir Aziz - who was the principal adviser to the government in the ministry of finance - Raghuram Rajan and Percy Mistry, had listed the operational efficiencies, which could be gained by having an independent debt management office.

These include eliminating a conflict of interest involving a central bank setting shortterm interest rates and selling bonds for the government; and increasing transparency.

The primary conflict, which is generally associated with a central bank managing sovereign debt relates to its inherent responsibility as the monetary authority, and its obligations as a debt manager.

It has been argued that the central bank will be biased towards a low interest regime to cut the costs of sovereign debt, at the risk of compromising its anti-inflation stance.

The Indian central bank has countered this by saying that in countries such as India, given the large size of the government borrowing programme, the sovereign debt management is much more than merely an exercise in resource-raising, as it could impact interest rates which, in turn, could have wider public policy implications.

Other arguments which have been put forward by those backing the RBI are that the size and dynamics of government borrowing programmes have a much wider influence on interest rate movements, systemic liquidity and even loan growth through the crowding out of private sector loan demand.

Besides, management of public debt, therefore, has necessarily to be seen as part of broader macroeconomic management framework involving various trade-offs.

According to them, once this is recognised, the centrality of central banks in this regard becomes quite evident and that only central banks have the requisite market pulse and instruments which an independent debt agency, driven by narrow objectives, will not be able to do.

The concern which has been flagged off is that if debt management is moved away from the RBI to DMO, which could function as an extended arm of the ministry of finance, the possibility of conflict of interest is greater as the government is the owner of the majority of banks in India.

This conflict of interest is more potent in the backdrop of banking sector continuing to be the dominant player for government market borrowing, with banks holding over 50% of outstanding government securities.

Autonomy for RBI

RBI being the architect of the monetary policy requires autonomy to be effective.Advocates of central bank independence argue that a central bank should be autonomous to manage money, credit and exchange rate dynamics in the globalizing economy. It helps check populist pressures and schemes that the political leadership may be tempted to indulge in. For example, the RBI was under pressure in 2013 from GOI to reduce rates to allow banks to lend easy to corporates and consumers to stimulate growth even as the inflation was rising. It resisted as it had autonomy.

Others believe that the elected governments should have the final say within which RBI should be autonomous both while tendering advice and also with enough discretionary powers. For example, fixing CRR and SLR as it deems fit with the amendments to the RBI Act in 2006.

Abenomics in Japan under Shinzo Abe since 2013 has been following unconventional monetary policy where huge money supply was generated to bring down the value of Yen and export and improve economy. It is a case of political priorities dictating the monetary policy.

The recent measures to make RBI independent are

- replacement of adhoc treasury bills with WMA from 1997
- FRBM Act empowers RBI with autonomy- no primary borrowing from 1-4-2006.
- RBI Act amended in 2006

The arguments in favour of autonomy are:

- monetary stability which is essential for the efficient functioning of the modern economic system can be best achieved if professional Central bankers with the long term perspective are given charge . Otherwise, political leadership may be tempted to populism
- without such autonomy, government tends to be profligate with its policies of automatic monetization
- monetary credibility is high in public perception if professionals manage it.

The arguments against are:

- democratic systems are run with Parliament and Cabinet making all important policies
- monetary policy is an integral policy of the overall economic policy and so RBI has to subordinate itself to the larger objective.

The best course is to have a middle path where autonomy should be linked to performance like in the policy of 'inflation targeting' where the central bank should justify its autonomy with performance in the field of management of prices at reasonable levels.

* Lender of last resort – Augest

Money Supply

This refers to the total volume of money circulating in the economy. Money supply can be estimated as narrow or broad money.

M1 equals the sum of currency with the public and demand deposits with the banks. It is the narrow money.

M3 or the broad money , as it is also known , includes time deposits (fixed deposits), savings deposits with post office saving banks and all the components of M1.

These notions are important for the RBI to understand the demand in the economy so that it can gauge inflation, demand and so on for it to adjust the same.

Liquidity trap

A **liquidity trap** is a situation in which injections of cash into the private banking system by a central bank fail to lower interest rates and hence fail to stimulate economic growth. A liquidity trap is caused when people hoard cash because they expect an adverse event such as deflation, insufficient aggregate demand, or war. Characteristics of a liquidity trap are short-term interest rates that are near zero and fluctuations in the monetary base(printed money) that fail to translate into fluctuations in general price levels. It means, more and easy money fails to see price rise which can signal demand growth in the economy. To come out of liquidity trap, QE is attempted.

Quantitative easing

The term quantitative easing describes an unconventional form of monetary easing used to stimulate an economy. It involves the central bank to buy financial instruments which in ordinary times are not accepted for OMOs- for example, the housing market securities that were discredited in the USA since 2008. It is a step that is taken after the interest rate reduction to very low levels and similar downward adjustment of reserve ratios like CRR fail to induce any positive change. It involves printing fresh currency and de-risking lending as rates and supply of money ease to unprecedented levels. Central bank uses unconventional means, other than the usual monetary policy tools, to flood the financial system with new money through quantitative easing.

Federal Reserve of the US (its central bank like the RBI) used quantitative easing to overcome the liquidity crisis since the fall of Lehman Brothers in 2008 September when many banks went bankrupt and credit froze. It has worked as US came out of recession. It was delivered in three tranches- QWE 1,2 and 3. By the end of 2013, QE3 is under operation and may taper- wound down ,by the middle of 2014. World is worried as US dollar is a global currency and not merely a national currency. It has impact on the economies and financial markets in other countries and want to be consulted – G20 St. Petersburg summit in 2013 where Dr.Singh urged to be consulted.

FSDC

Financial Stability and Development Council is apex-level body constituted by government of India. The idea to create such a super regulatory body was first mooted by Raghuram Rajan Committee in 2008.The recent global economic meltdown has put pressure on governments and institutions across globe to regulate the financial sector towards greater stability.

The new body envisages to strengthen and institutionalise the mechanism of maintaining financial stability, financial sector development,inter-regulatory coordination along with monitoring macro-prudential regulation of economy.

Its Chairperson is the Union Finance Minister of India

Members are :

- Governor Reserve Bank of India (RBI),
- Finance Secretary and/ or Secretary, Department of Economic Affairs (DEA),
- Secretary, Department of Financial Services (DFS),
- Chief Economic Advisor, Ministry of Finance,
- Chairman, Securities and Exchange Board of India (SEBI),
- Chairman, Insurance Regulatory and Development Authority (IRDA),
- Chairman Pension Fund Regulatory and Development Authority (PFRDA),
- Joint Secretary (Capital Markets), DEA, will be the Secretary of the Council,
- The Chairperson may invite any person whose presence is deemed necessary for any of its meeting(s).

Responsibilities

- Financial Stability
- Financial Sector Development
- Inter-Regulatory Coordination
- Financial Literacy
- Financial Inclusion
- Macro prudential supervision of the economy including the functioning of large financial conglomerates
- Coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB)and any such body as may be decided by the Finance Minister from time to time.

Macro prudential analysis is a method of economic analysis that evaluates the health, soundness and vulnerabilities of a financial system. Macro prudential analysis looks at the health of the underlying financial institutions in the system and performs stress tests(simulate financial crises and check impact on the banks and other financial institutions) and scenario analysis to help determine the system's sensitivity to economic shocks.

In October 2013, FSDC met in the context of rupee crisis and the global factors. The government decided to reach out to sovereign wealth funds to minimise the impact of US Federal Reserve's tapering of quantitative easing on Indian markets. FM asked the financial sector regulators to take preventive steps before stimulus rollback starts early 2014.□□At the eighth meeting of the Financial Stability and Development Council (FSDC), Chidambaram emphasized the opportunity available due to the postponement of the reversal of the monetary policies in the United States should be utilized to further address the macroeconomic imbalances. Withdrawal of the $85 billion-a-month bond buying programme by the US, which would lead to outflow of funds from emerging markets, was deferred by the Federal Reserve in September 2013.