RBI to infuse Rs 1 lakh crore – LTRO – RBI Reforms

Part of: GS-III- RBI reforms (PT-MAINS-PERSONALITY TEST)

Context

RBI Governor Shaktikanta Das announced new measures to maintain adequate liquidity in system, facilitate bank credit flow and ease financial stress. RBI announced ₹50,000 crore worth of targetted LTRO and a cut in reverse repo rate.

As India entered into the second phase of a nationwide lockdown to combat coronavirus, Reserve Bank of India (RBI) Governor Shaktikanta Das announced new measures to boost liquidity, expand bank credit flow and ease financial stress. To benefit NBFCs and micro-financial institutions, the central bank said it will conduct targetted long-term repo operations (TLTRO) 2.0 worth ₹50,000 crore. After cutting the benchmark lending rate by 75 bps three weeks ago, the RBI today cut the reverse repo rate to 25 basis points to 3.75%. The central bank has also asked all banks to not make any dividend payments to shareholders keeping in mind the financial challenges during the Covid-19 pandemic.

Important Points

- RBI will monitor evolving situation continuously, use all its tool to deal with pandemic fallout.

- Loans given by NBFCs to real estate companies to get similar benefit as given by scheduled commercial banks.

- LCR requirement of banks brought down to 80% from 100%; to be restored in phases by April next year.

- Inflation is on a declining trajectory, could recede even further.

- Banks shall not make any dividend payments until further orders.

- NPA classification for banks will exclude the moratorium period.

- Economic activities have come to a standstill during lockdown.

- ₹50,000 crore special finance facility to be provided to financial institutions such as Nabard, Sidbi, NHB.

- No change in repo rate which is decided by MPC.

- Reverse repo rate cut by 25 bps to 3.75%.

- New measures aimed at maintaining adequate liquidity in system, facilitate bank credit flow, ease financial stress.

- TLTRO 2.0 operations of ₹50,000 crore will be conducted.

- To maintain adequate liquidity in the system, we have decided to take additional measures.
Redemption pressures faced by some mutual funds have moderated.

Automobile production, sales declined sharply in March; electricity demand has fallen sharply.

Covid-19 impact is not captured in IIP data for Feb.

ATM operations stood at 91%, no downtime on internet and mobile banking.

- India is expected to post sharp turnaround in 2021-22, says RBI Governor quoting IMF projection. IMF projection of 1.9% GDP growth for India is highest in G20.

- Banks, financial institutions have risen to occasion to ensure normal functioning during outbreak of pandemic.

- RBI governor cites developments that bode well for rural demand.

- Financial market situation has deteriorated in some areas.

- Rupee rises 29 paise to 76.58 against US dollar in early trade.

- Sensex rose over 1,000 points before RBI's announcement.

PT PICKUPS

1. Long-term Repo Operations

- Under LTRO, RBI will conduct term repos of one-year and three-year tenors of appropriate sizes for up to a total amount of Rs 1 lakh crore at the prevailing repo rate.
- As banks get long-term funds at lower rates, their cost of funds falls. In turn, they reduce interest rates for borrowers.
- LTRO helps RBI to ensure that banks reduce their marginal cost of funds-based lending rate, without reducing policy rates.

Objectives of LTRO

- To assure banks about the availability of durable liquidity at reasonable cost relative to prevailing market conditions.
- Further encourage banks to undertake maturity transformation smoothly and seamlessly so as to augment credit flows to productive sectors.
  - Maturity transformation is when banks take short-term sources of finance, such as deposits from savers, and turn them into long-term borrowings, such as mortgages.

2. Monetary Policy Committee

- It is a statutory and institutionalized framework under the Reserve Bank of India Act, 1934, for maintaining price stability, while keeping in mind the objective of growth.
- The Governor of RBI is ex-officio Chairman of the committee.
- The MPC determines the policy interest rate (repo rate) required to achieve the inflation target (4%).
- An RBI-appointed committee led by the then deputy governor Urjit Patel in 2014
recommended the establishment of the Monetary Policy Committee.

Repo Rate

- It is the **rate at which the central bank** of a country lends money to commercial banks **in the event of any shortfall of funds** (Reserve Bank of India, in case of India).
- It is used by monetary authorities **to control inflation**.
- In the event of inflation, central banks increase the repo rate as this acts as a disincentive for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation.
- The central bank takes the contrary position in the event of a fall in inflationary pressures.
- Ideally, a low repo rate should **translate into low-cost loans for the general masses**. When the RBI slashes its repo rate, it expects the banks to lower their interest rates charged on loans.

3. About RBI

**History**

- The Reserve Bank of India was established on **April 1, 1935** in accordance with the provisions of the **Reserve Bank of India Act, 1934**.
- The Central Office of the Reserve Bank was initially established in Calcutta but was **permanently moved to Mumbai in 1937**. The Central Office is where the Governor sits and where policies are formulated.
- Though **originally privately owned**, since nationalization in 1949, the Reserve Bank is fully owned by the Government of India.

**Preamble**

- To regulate the **issue of Bank notes** and keeping of reserves with a view to **securing monetary stability** in India and generally to **operate the currency and credit system** of the country to its advantage.
- To have a modern monetary policy framework to meet the challenge of an increasingly complex economy.
- To **maintain price stability** while keeping in mind the objective of growth.

**Structure**

- The Reserve Bank's affairs are governed by a **central board of directors**. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act.
- The directors are appointed/nominated for a period of four years.

**Constitution**

- **Official Directors (central board of directors)**
  - **Full-time**: Governor and not more than four Deputy Governors
- **Non-Official Directors**
  - **Nominated by Government**: ten Directors from various fields and two government Official
  - **Others**: four Directors - one each from four local boards (regional)

**Main Functions**
1. Monetary Authority:

- It implements and monitors the monetary policy and ensures price stability while keeping in mind the objective of growth.

An amendment to RBI Act, 1934, was made in May 2016, providing the statutory basis for the implementation of the flexible inflation targeting framework.

Section 45ZB of the amended RBI Act, 1934, also provides for an empowered six-member Monetary Policy Committee (MPC) to be constituted by the Central Government by notification in the Official Gazette.

Monetary Policy Committee

- It was created in 2016.
- It was created to bring transparency and accountability in deciding monetary policy.
- MPC determines the policy interest rate required to achieve the inflation target.
- Committee comprises of six members where Governor RBI acts as an ex-officio chairman. Three members are from RBI and three are selected by government.
- Inflation target is to be set once in a five year. It is set by the Government of India, in consultation with the Reserve Bank.

Current inflation target is pegged at 4% with -2/+2 tolerance till March 31, 2021.

2. Regulator and Supervisor of the Financial System:

- Prescribes broad parameters of banking operations within which the country's banking and financial system functions such as issuing licenses, branch expansion, liquidity of assets, amalgamation of banks etc.
- Objective: maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services such as commercial banking, co-operative banking, to the public.

3. Manager of Foreign Exchange:

- Manages the Foreign Exchange reserves of India.
- It facilitates external trade and payment and promotes orderly development and maintenance of foreign exchange market in India.
- It also maintains external value of rupee.

4. Issuer of Currency:

- Issues and exchanges or destroys currency and coins not fit for circulation.
- Objective: to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5. Developmental Role:

- Performs a wide range of promotional functions to support national objectives such as making institutional arrangements for rural or agricultural finance.
- Commercial banks lend loans to small-scale industrial units as per the directives (Priority Sector Lending) issued by the Reserve Bank of India time to time.
6. Financial Inclusion:

- The Reserve Bank has selected a bank led model for financial inclusion in India. RBI has undertaken a series of policy measures. Some of the important ones are:
  - **No Frills Accounts** – account either with nil or very low minimum balance as well as charges that would make such accounts accessible to vast sections of population.
  - **Use of Technology** – devices such as ATMs, hand held devices to identify user accounts through a card and biometric identifier, Deposit taking machines and Internet banking and Mobile banking facility to provide the banking services to all sections of society with more ease.

7. Related Functions:

- Banker to the Government: performs merchant banking function for the central and the state governments.
- It is entrusted with central govt.’s money, remittances, exchange and manages its public debt as well.
- Banker to banks: maintains banking accounts of all scheduled banks. It also acts as lender of last resorts by providing fund to banks.

**Independence of RBI**

- Under section 7 of the RBI Act, the central government may from time to time give such directions to the RBI as it may, after consultation with the Governor of the Bank, consider necessary in the public interest. Moreover, there is no legal act mandating autonomy of the RBI.
- Yet, RBI has always been looked upon as an autonomous body which has under its umbrella all commercial banks, be it PSBs or private banks or foreign banks.
- It is not only vested with the powers to formulate the monetary policy but also to monitor the functioning of all banks.
- To play its role effectively, autonomy in its functioning is sine qua non for RBI.
- However, the independence of RBI has been challenged many times due to a continued tug of war for wresting more power between the bank and the govt.
- The main reasons for this have been:
  - RBI’s failure to check the growth of Non Performing Assets.
  - Reduced liquidity in the economy due to tight monetary policy followed by RBI.
  - Corrective measures taken by RBI to clean up the banking system which are not seen very positively by the government
  - Clash between short term populist agenda of the government and long term view for price stability taken by RBI.
  - Regulation of Public Sector Banks: One important limitation is that the Reserve Bank is statutorily limited in undertaking the full scope of actions against public sector banks (PSBs) – such as asset divestiture, replacement of management and Board, license revocation, and resolution actions such as mergers or sales — all of which it can and does deploy effectively in case of private banks.
  - Erosion of statutory powers of the central bank through piece-meal legislative amendments that directly or indirectly eat at separation of the central bank from the government.

**RBI’s Important Publication (half yearly)**
4. ‘Operation Twist’

The Reserve Bank of India has announced that it will carry out US-style 'Operation Twist' to bring down interest rates.

Important Points

- RBI will conduct simultaneous purchase and sale of government securities under Open Market Operations (OMO) for ₹10,000 crore each.
- It will purchase the longer-term maturities (i.e. government bonds maturing in 2029), and simultaneously sell the shorter duration ones (i.e. short-term bonds maturing in 2020).
- The eligible participants can bid or submit offers in electronic format on RBI’s Core Banking Solution (E-Kuber).

‘Operation Twist’

- ‘Operation Twist’ is when the central bank uses the proceeds from the sale of short-term securities to buy long-term government debt papers, leading to easing of interest rates on the long term papers.
- Operation Twist first appeared in 1961 as a way to strengthen the U.S. dollar and stimulate cash flow into the economy.
- In June 2012, Operation Twist was so effective that the yield on the 10-year U.S. Treasury dropped to a 200-year low.

Open Market Operations

- Open Market Operations (OMO) is one of the quantitative (to regulate or control the total volume of money) monetary policy tools which is employed by the central bank of a country to control the money supply in the economy.
- OMOs are conducted by the RBI by way of sale or purchase of government securities (g-secs) to adjust money supply conditions.
- The central bank sells g-secs to remove liquidity from the system and buys back g-secs to infuse liquidity into the system.
- These operations are often conducted on a day-to-day basis in a manner that balances inflation while helping banks continue to lend.
- RBI carries out the OMO through commercial banks and does not directly deal with the public.
- The RBI uses OMO along with other monetary policy tools such as repo rate, cash reserve ratio and statutory liquidity ratio to adjust the quantum and price of money in the system.