



# NABARD

Grade B - (Phase 1 & 2)

National Bank for Agriculture and Rural Development (NABARD)

Volume - 4

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Economic and Social Issues



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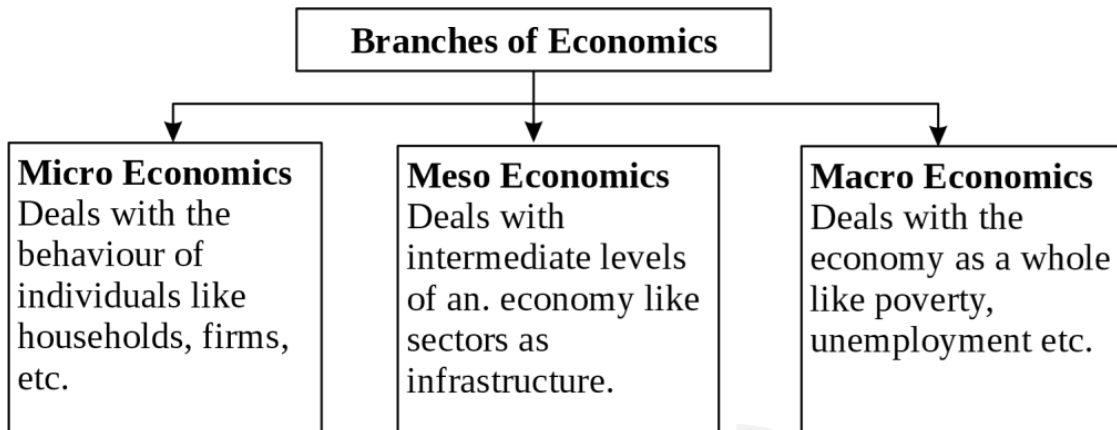
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# 1

## CHAPTER

# Basic Concepts of Economy

Economics is a social science concerned with the production, distribution and consumption of goods and services.



## Types Of Economy

- **Capitalist Economy:** Based on *laissez faire* with minimal government intervention. Private enterprises decide production, pricing, and supply based on market demand, and prices are determined by supply and demand forces.
- **Socialist Economy:** The government controls output and pricing, focusing on distributing goods based on need rather than affordability. Essential services like health care are provided free to citizens.
- **Mixed Economy:** Combines elements of both capitalism and socialism. The government intervenes to achieve social goals, redistributes wealth through taxes, and promotes social objectives alongside private sector activity.
- **Open Economy:** Engages in economic relations with the rest of the world. The demand for domestic goods includes domestic consumption, investment, government spending, and exports minus imports. Exports provide an additional demand for domestic goods and services.
- **Closed Economy:** Has no economic interactions with other countries. In a closed economy, saving, investment, GDP, and GNP are equal, while in an open economy, these may differ due to international trade.

## Schools of Economic Thought

- **Classical View:** Believes in free markets as the most efficient way to allocate resources and advocates for limited government involvement, acting only as a fair and strict referee.
- **Keynesian View:** Argues that markets alone cannot efficiently allocate resources and it supports active government intervention to reallocate resources and stabilize the economy.

## Structural Composition of an Economy

- **Primary Sector:** Refers to industries involved in the extraction of natural resources or the production of raw materials. Examples include fishing, farming, mining and more.
- **Secondary Sector:** Encompasses industries involved in the manufacturing of usable or finished goods. Examples include heavy industries such as steel, automotive and light industries such as food and cosmetics.

- 
- **Tertiary Sector:** Refers to industries that offer services to businesses or end consumers. Examples include healthcare, insurance and more.
  - **Quaternary Sector:** Involves industries focused on the creation and dissemination of knowledge. Examples include research and development, education etc.
  - **Quinary sector:** Involves the highest levels of decision-making in an economy. Examples include NITI Aayog members, scientists.

## Sectors of Economy

- **Formal Sector:** This sector consists of businesses that are officially registered with the government and are governed by various regulations, such as the Companies Act, Factories Act and Labour laws etc.
- **Informal Sector:** This sector consists of businesses that operate without legal regulation or the maintenance of regular financial records. Examples include landless laborers, farmers and vendors.

The **Real sector** of an economy drives economic output and GDP growth, encompassing activities like farming or textile production, which directly contribute to the economy's productivity and meet aggregate demand. It is essential for economic sustainability. In contrast, the **Financial sector** includes institutions providing financial services such as banks, insurance companies and investment firms, which generate revenue through loans and mortgages.

## Goods

- Goods are products or services that satisfy people's needs and wants. They can be physical items, services, or a mix of both, and anything that offers value to consumers is considered a good.

### **Types of Goods in an Economy:**

- **Intermediate goods:** Products used by producers as inputs in the production process. Example: Rubber for tyres.
- **Final goods:** Items intended for final consumption, without further transformation or production. Example: Bicycle.
- **Consumer goods:** Goods purchased by consumers for personal use. Example: Sugar.
- **Capital goods:** Durable items utilized in the production process, such as machinery and tools.
- **Luxury goods:** Products for which demand increases with higher income levels. Example: Gold.
- **Complementary goods:** Goods that are used together. Example: Bread and butter, pen and refill.
- **Substitute goods:** Products that serve as alternatives to each other. Example: Tea and coffee.
- **Veblen (Snob) goods:** Goods for which demand increases as their price rises, often because people perceive them as better. Example: A rolex watch, private jets.
- **Giffen goods:** Goods where demand increases as prices rise, often considered inferior goods. Example: Bajra.
- **Public goods:** Goods that are non-rivalrous (one person's consumption doesn't reduce availability for others) and non-excludable. When the government provides a commodity for free, the opportunity cost shifts from the consumers to taxpayers. This means that while individuals receive the good at no cost, the expense is covered by the general population through taxes. Example: Parks, defense.
- **Private goods:** Goods that are both rivalrous (one person's consumption limits others') and excludable (can be restricted to specific users). Example: Club membership, houses.
- **Merit goods:** Goods with positive externalities, such as education or healthcare.
- **Demerit goods:** Goods with negative externalities. Example: liquor, cigarettes.

## Stock and Flows

- Stocks refer to assets or goods that are present at a particular moment in time, while flows represent the quantities occurring over a specified period.
- Capital goods, like machinery, are considered stocks, whereas the changes in capital goods over time are classified as flows.

## Law of Demand

- The Law of Demand states that, assuming all other factors are unchanged, when the price of a good or service increases, the quantity demanded by consumers decreases, and vice versa.
- For example, if smartphone prices fall, consumers are more likely to buy more. This inverse relationship between price and demand is a key principle in economics. However, this law applies only to normal goods.

### 1. Demand Curve

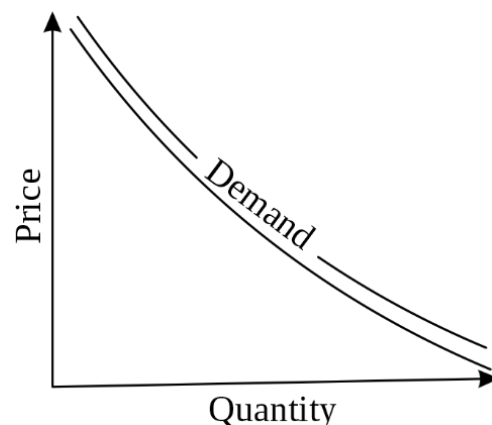
- ✓ A price change usually leads to an inverse change in quantity demanded, with the demand curve sloping downward.
- ✓ In some cases, a price decrease can reduce demand, and a price increase can boost it, causing the curve to slope upward.
- ✓ The Speculative Effect can also reverse this trend, as consumers anticipate future price hikes.
- ✓ Factors such as changes in income, prices of related goods and preferences can shift the demand curve.
- ✓ An increase in these factors shifts the curve rightward, while a decrease shifts it leftward.

### 2. Elasticity of Demand

- ✓ It measures how responsive the quantity demanded of a good or service is to price changes. It reveals how sensitive consumers are to variations in price.

### 3. Types of Elasticity of Demand

- ✓ **Perfectly Elastic:** Infinite change in quantity for a small price change.
- ✓ **Perfectly Inelastic:** No change in quantity regardless of price changes.
- ✓ **Relatively Elastic:** Large change in quantity for a small price change.
- ✓ **Unitary Elastic:** Proportional change in quantity and price.
- ✓ **Relatively Inelastic:** Small change in quantity for a large price change.



## Law of Supply

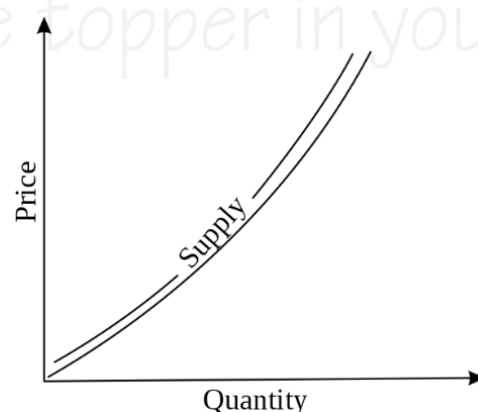
- The Law of Supply states that as prices rise, the quantity supplied increases, and as prices fall, the quantity supplied decreases.
- For instance, higher coffee prices encourage farmers to grow more, while lower prices reduce production. This reflects the direct relationship between price and supply.

### 1. Elasticity of Supply

- ✓ It measures how responsive the quantity supplied of a good or service is to price changes.
- ✓ It helps understand how producers adjust their output in response to price fluctuations.

### 2. Types of Elasticity of Supply

- ✓ **Relatively Elastic Supply:** Quantity supplied changes more than proportionally to price.
- ✓ **Unitary Elastic Supply:** Quantity supplied changes proportionally to price.
- ✓ **Relatively Inelastic Supply:** Quantity supplied changes less than proportionally to price.



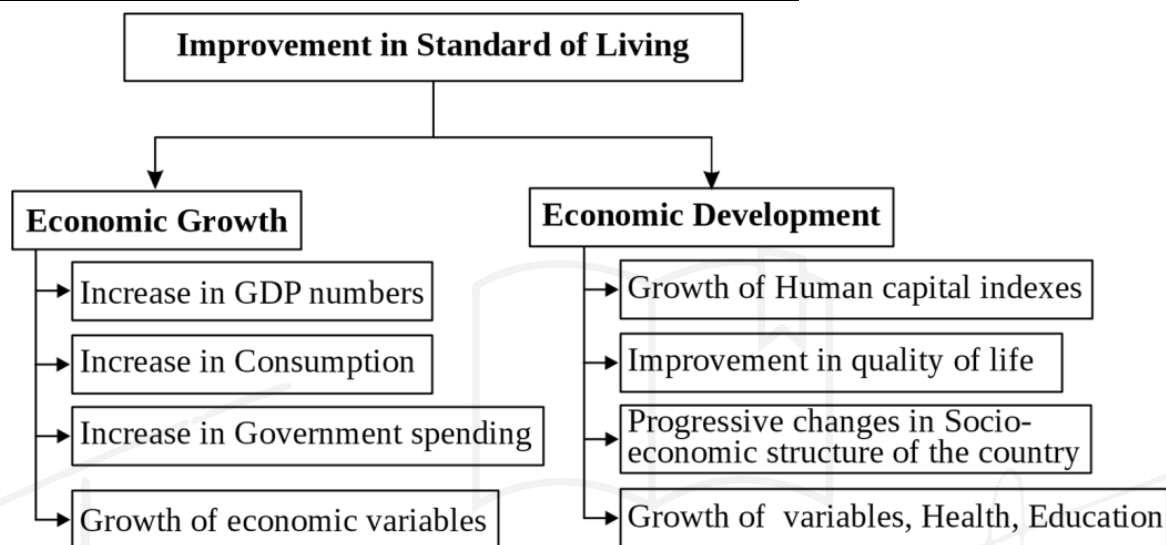
## Income and Cross Elasticity

- **Income Elasticity:** Measures the response of quantity demanded or supplied to income changes.
- **Cross Elasticity:** Analyzes how the quantity demanded or supplied of one good responds to price changes of another good.

## Economies of Scale

- Economies of scale occur when a company becomes more efficient in production, leading to cost advantages. Companies can lower product costs and increase production to achieve economies of scale.
- Example: Large supermarket chains benefit from economies of scale due to greater cash flow and a larger customer base. By purchasing groceries in bulk from suppliers, they reduce costs, enabling them to sell at lower prices compared to independent grocers.

## Economic Growth V/s Economic Development



## Important Economists and Their Books

Economist/Author	Book Title	Key Concept / Contribution
Gunnar Myrdal	Economic Theory and Under-developed Regions	Circular cumulative causation; regional inequality
Albert O. Hirschman	The Strategy of Economic Development	Unbalanced growth strategy in development economics
Nicholas Kaldor	Strategic Factors in Economic Development	Importance of manufacturing and increasing returns
Adam Smith	The Wealth of Nations (1776)	Classical economics; invisible hand; division of labor
Thomas R. Malthus	An Essay on the Principle of Population (1798)	Population grows geometrically, food supply arithmetically

## Circular Economy

- A circular economy is an economic model aimed at **eliminating waste** and **continually reusing resources**, in contrast to the traditional **linear model** of "take-make-dispose".
- Promotes recycling, reusing, and energy-efficient systems.
- Reduces the need for primary resource extraction.
- Promotes **closed-loop systems** to minimize waste.
- Waste from one process can become input for another.
- Encourages lean manufacturing and **industrial symbiosis**.

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## Care Economy vs Monetized Economy

The **care economy** consists of **unpaid or underpaid work** related to caregiving and domestic activities, largely performed by women at home. In contrast, the **monetized economy** includes market-based economic activities that contribute to **GDP**.

### Key difference-

Aspect	Care Economy	Monetized Economy
<b>Nature of Work</b>	Unpaid domestic and care tasks (e.g., cooking, childcare)	Market-based goods and services exchanged for money
<b>GDP Valuation</b>	Not included in GDP or national accounts	Directly contributes to GDP and national income
<b>Gender Composition</b>	Largely female-dominated, often invisible	Male-dominated historically; increasingly gender-diverse
<b>Workplace</b>	Mainly at home or within communities	Formal/informal markets (factories, shops, offices)
<b>Regulation</b>	Lacks formal contracts or wages	Covered by labour laws, minimum wage, and protections
<b>Social Perception</b>	Seen as moral/familial duty	Viewed as productive economic participation
<b>Time Investment</b>	Women spend <b>4.5 hours/day</b> , men <b>0.5 hours/day</b> (NSO 2019)	Paid work is compensated monetarily

### Integrating Care Economy into Monetized Economy through Women Empowerment:

#### 1. Recognition and Measurement:

- ✓ Conduct **Time Use Surveys** and adopt **satellite accounts** to value unpaid care work.
- ✓ Example: India's **Time Use Survey 2019** revealed gender disparities; countries like **Australia and South Korea** include care work in GDP accounts.

#### 2. Expansion of Paid Care Work:

- ✓ Formalize child care, elderly care, and domestic help through **certified paid positions**.
- ✓ Example: **Kerala** invests in Anganwadi modernization, creating employment for women.

#### 3. Upskilling and Certification:

- ✓ Use **Skill India** and **Domestic Workers Sector Skill Council** for professional training.
- ✓ Example: **NSDC programs** train women in geriatric care, hospitality, and child services.

#### 4. Women-Led Microenterprises and Cooperatives:

- ✓ Empower women to run income-generating services based on care skills.
- ✓ Example: **Kudumbashree (Kerala)** supports SHGs in community kitchens and daycare centres.

#### 5. Policy and Legal Reforms:

- ✓ Extend **social security** and labor protections to informal caregivers.
- ✓ Example: **e-Shram Portal** registers and protects unorganized workers, including domestic help.

#### 6. Gender-Sensitive Infrastructure:

- ✓ Investment in **public transport, water, sanitation** reduces women's unpaid workload.
- ✓ Example: **Ujjwala Yojana** saves time in firewood collection, freeing women for economic work.

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### 7. Promoting Men's Participation:

- ✓ Encourage shared household responsibilities through awareness and workplace policies.
- ✓ Example: **Scandinavian countries** provide paternity leave, enabling women's workforce participation.

### 8. Gender Budgeting:

- ✓ Allocate funds to empower women and reduce unpaid tasks.
- ✓ Example: Union Budget's **Gender Budget Statement** supports **PM Matru Vandana Yojana** and **ICDS** programs.

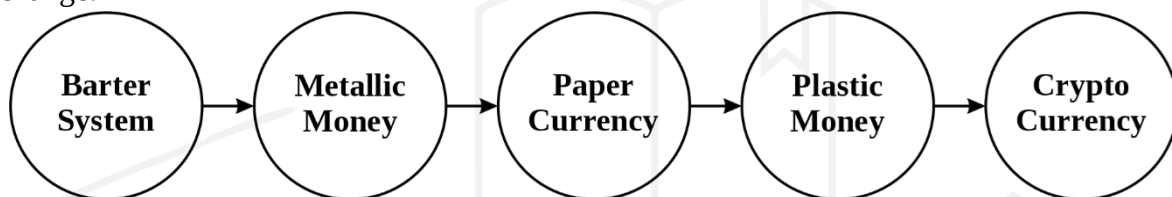


ToppersNotes  
Unleash the topper in you

- The money and banking system comprises institutions like central and commercial banks that manage currency, regulate interest rates, and provide loans.
- It ensures economic stability, growth, and efficient resource allocation by facilitating the flow of money and credit.

## Money & Its Evolution

- Money is defined as something widely accepted by society as a medium of exchange, serving as a unit of account, store of value, and a means for debt repayment.
- It emerged as a more efficient alternative to the barter system, where goods and services were exchanged directly without a monetary intermediary.
- The barter system faced challenges, such as the issue of "double coincidence of wants" (both parties needing what the other offers) and the difficulty of storing goods without loss of value.
- These problems led to the development of money as a common, easily transferable medium of exchange.



### 1. Functions of Money

- ✓ **Medium of Exchange:** Money eliminates the double coincidence of wants, enabling smooth economic transactions.
- ✓ **Unit of Account:** It standardizes the value of goods and services, making price comparison easy.
- ✓ **Store of Value:** Money preserves wealth, offering liquidity for spending and saving.
- ✓ **Standard of Deferred Payments:** It enables future payments in transactions.
- ✓ **Means of Payment:** Money settles debts, taxes and obligations.

#### Legal tenders

- Currency notes and coins are also called legal tenders as they **cannot be refused** by any citizen of the country for settlement of any kind of trans-action.
- Cheques drawn on savings or current accounts, however, can be refused by anyone as a mode of payment. Hence, **cheques are not legal tenders.**

### 2. Types of Money

- ✓ **Commodity Money:** Money with intrinsic value, such as gold or silver which holds worth independently of any government.
- ✓ **Paper Money:** Currency notes issued by the government or central bank, representing a monetary value.
- ✓ **Metallic Money:** Money made from precious metals like gold and silver, valued for portability, high density and convenience.
- ✓ **Bank Money:** Money held in demand deposits at commercial banks, accessible through cheques; considered "near money."
- ✓ **Fiat Money:** Government-issued money not backed by a physical commodity, deriving value from the issuing authority's guarantee, like currency notes and coins in India.

- ✓ **Plastic Money:** Physical cards, like debit, credit, or cash cards, used in place of cash transactions.
- ✓ **Helicopter Money:** A policy involving printing and distributing money to stimulate the economy through increased spending or tax cuts.
- ✓ **Bitcoins:** Bitcoin, introduced in 2009, is a digital currency that allows instant payments without the need for a central authority. It operates on an open-source protocol, and users can acquire Bitcoin through mining, exchanges, or peer-to-peer transactions.
- ✓ **Non-Fungible Token (NFT):** They are unique digital assets used to verify ownership of items like art or real estate and cannot be subdivided or exchanged one-to-one due to differing values. They are not banned but operate in grey zones.
- ✓ **Central Bank Digital Currency:** A CBDC is a digital legal tender issued by a central bank, backed by it for stability. Unlike cryptocurrencies, it's equivalent to fiat currency and exchangeable one-to-one. The RBI Governor recently highlighted the innovative features of India's **e-rupee**.

Digital Currency	Cryptocurrency
Normally backed by Central Bank (The RBI already introduced it in India)	Not backed by the central bank
Centralised	Decentralised
Not as transparent as only the sender, receiver and the banking authorities will be aware of the transactions	Transparent due to distributed ledger system; details regarding cryptocurrency transactions in public domain.

### Need for Digital Currency in India

1. **Rising Demand for Digital Transactions** – Rapid growth of UPI and digital payments necessitates a sovereign-backed digital alternative to private payment systems.
2. **Financial Inclusion** – Enables access to formal financial services for unbanked and underbanked populations through digital wallets.
3. **Reducing Cost of Cash Economy** – Lowers currency printing, transportation, storage, and management costs borne by RBI and banks.
4. **Enhanced Transparency & Fraud Prevention** – Improves traceability of transactions, reducing black money, counterfeiting, and illicit financing.
5. **Better Monetary Policy Control** – Enables real-time tracking of money supply and improves transmission of monetary policy decisions.
6. **Reducing Dependence on Private Cryptocurrencies** – Provides a regulated, sovereign digital alternative to volatile private virtual assets.
7. **Strengthening Digital Economy Vision** – Supports Digital India and fintech ecosystem growth.

### Benefits of Digital Currency

1. **Sovereign Guarantee** – Backed by RBI, ensuring safety and legal tender status.
2. **Faster & Efficient Payments** – Enables instant peer-to-peer and cross-border transactions.
3. **Lower Transaction Costs** – Reduces intermediary costs in payment settlement systems.
4. **Financial System Efficiency** – Streamlines settlement and clearing processes.
5. **Reduced Counterfeit Risk** – Digital form eliminates fake currency circulation.
6. **Programmable Payments** – Allows targeted transfers such as DBT with end-use conditions.
7. **Enhanced Cross-Border Trade** – Facilitates cheaper and faster international remittances.

### Challenges in implementation of digital currency

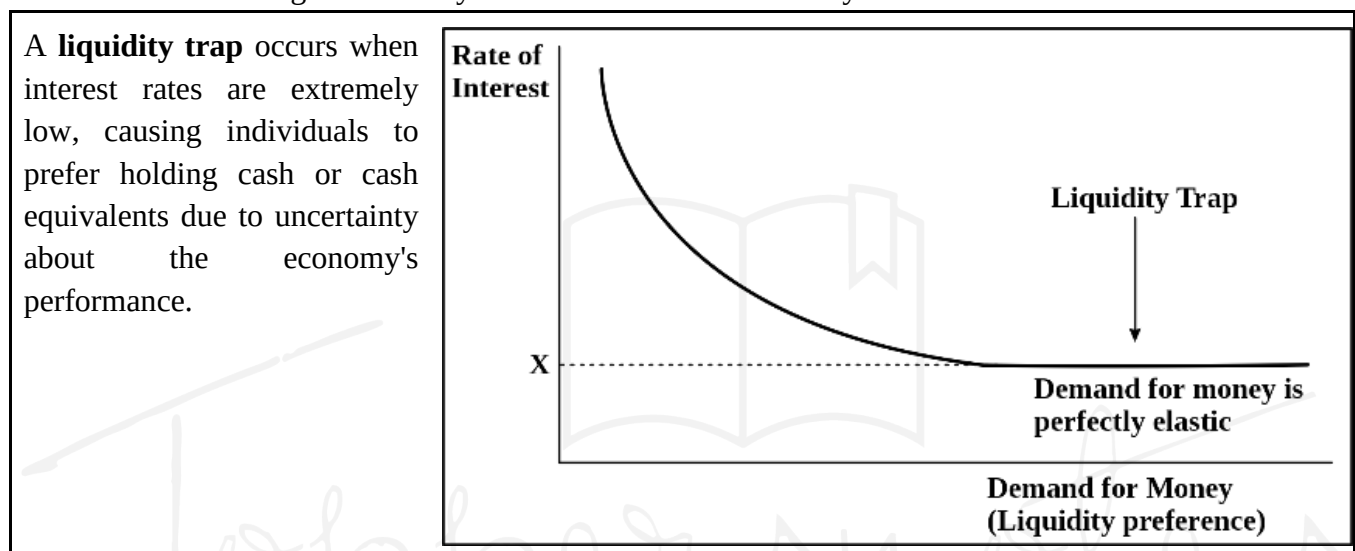
1. **Cybersecurity Risks** – Vulnerability to hacking and digital fraud.
2. **Privacy Concerns** – Balancing transaction traceability with citizens' data protection.
3. **Banking Disintermediation Risk** – Large-scale shift to CBDC may reduce bank deposits.

4. **Technological Infrastructure Gaps** – Digital divide in rural and remote areas.
5. **Legal & Regulatory Framework** – Need for robust amendments in RBI Act and IT laws.
6. **Monetary Stability Concerns** – Risk of rapid capital flight during financial stress.
7. **Operational Complexity** – Ensuring scalability, interoperability, and system resilience.

## Demand & Supply of Money

### 1. Demand for Money:

- ✓ **Transaction Motive:** This motive for holding money is to conduct deals when income and expenditure timings differ. It is directly proportional to real GDP and price level.
- ✓ **Precautionary Motive:** It refers to the desire of people to hold cash reserves for certain unforeseen contingencies like sickness, accident etc. Higher the income of the individual, higher will be the cash balance for precautionary motive.
- ✓ **Speculative Motive:** Speculation involves anticipating future asset values; if people expect asset prices to rise, they invest in them to make future profits, and if they expect prices to fall, they convert holdings into money to avoid losses. It is inversely related to the market rate of interest.



### 2. Bond Market Dynamics and Speculative Money Flows:

- ✓ An increase in money supply leads to higher bond purchases, raising bond prices and lowering interest rates.
- ✓ As interest rates fall, people expect future increases and anticipate capital loss, driving up speculative demand for money.
- ✓ Conversely, when interest rates are high, people expect a decrease and convert money into bonds, reducing speculative demand for money.

### 3. The Link Between Bond Yields and Interest Rates

- ✓ Bonds with fixed interest rates become more appealing when interest rates decrease, leading to higher demand and market value.
- ✓ Conversely, when interest rates rise, bond prices fall to align with the yields of newly issued bonds.
- ✓ Bond yield is calculated by dividing the annual interest by the current price, so when bond prices drop, yields increase, and when prices rise, yields decrease.

### 4. Supply of Money:

- ✓ Money Supply refers to the total stock of money in circulation among the public at a given time, excluding money held by the government, RBI (in the form of CRR), and commercial banks (in the form of SLR).
- ✓ It includes currency notes and coins, demand deposits (e.g., savings accounts), time deposits (e.g., fixed deposits), money in post office savings accounts, and inter-bank deposits (excluding CRR).

✓ **Measures of Money Supply:**

- Money supply measures are tools used to measure the money supply in an economy, with the Reserve Bank of India (RBI) using several aggregates:
  - ☞ **M0 (Reserve Money)** includes currency in circulation, bankers' deposits with the RBI and other deposits with the RBI.
  - ☞ **M1 (Narrow Money)** is the sum of currency held with the public and net demand deposits held by commercial banks.
  - ☞ **M2** includes M1 plus savings deposits with Post Office Savings Banks.
  - ☞ **M3 (Broad Money)** is M1 plus net time deposits with the banking system.
  - ☞ **M4** is M3 plus total deposits with Post Office Savings Organizations (excluding National Savings Certificates).

<b>Measures of Money Supply</b>		
<b>Most Liquid (Narrow Money)</b>	<b>M1</b> 1. Currency Notes 2. Coins 3. Demand Deposits with Bank (savings, current)	<b>M2</b> M1 + Post Office Savings Deposits
<b>Less Liquid (Broad Money)</b>	<b>M3</b> <b>M2</b> + Time deposits (up to 1 year) with banks + Call/term borrowings by banks	<b>M4</b> <b>M3</b> + Time deposits (over 1 year) with banks + Deposits

- ✓ In India, M0, M1, and M3 are most commonly used. The **RBI** also tracks new monetary aggregates like NM0, NM1, NM2 and NM3, which focus on the banking sector's balance sheet and liquidity like:
  - **NM0** is the sum of currency in circulation, bankers' deposits with the RBI, and other deposits with the RBI, which primarily include deposits from quasi-government institutions, foreign central banks and international agencies like the IMF.
  - **NM1 (Narrow Money)** includes currency with the public, current deposits with banks, the demand liabilities portion of savings deposits, and other deposits with the RBI. It represents currency and non-interest-bearing deposits in the banking sector.
  - **NM2** is NM1 plus short-term time deposits having maturity of up to one year.
  - **NM3 (Broad Money)** includes NM2, long-term time deposits and call/term funding from financial institutions, capturing the complete balance sheet of the banking sector.
- ✓ The Working Group also suggested the creation of **three Liquidity Aggregates- L1, L2, and L3** - alongside the New Monetary Aggregates.
  - **L1** is the sum of NM3 and all deposits with Post Office Savings Banks (excluding National Savings Certificates).
  - **L2** includes L1, term deposits, term borrowing and certificates of deposit from financial institutions (FIs).
  - **L3** is the sum of L2 and public deposits from non-banking financial companies (NBFCs).

**5. Determinants of Money Supply:**

- ✓ Money supply is determined by several factors in the economy as:

- 
- **Central Bank Policy:**
    - ☞ Open Market Operations: Buying or selling government securities to manage the money supply.
    - ☞ Reserve Requirements: The percentage of deposits banks must hold in reserve, affecting lending capacity.
  - **Commercial Bank Actions:**
    - ☞ Lending Practices: Banks influence money supply by deciding how much to lend to individuals and businesses.
  - **Public Preferences:**
    - ☞ Holding Money: The public's preference for holding cash or depositing it in interest-bearing accounts affects the money supply.
  - **Economic Activity:**
    - ☞ Velocity of Money: The rate at which money circulates in the economy impacts its effect on economic activity.
  - **Government Influence:**
    - ☞ Government Spending: Fiscal policies and government expenditure, especially if financed by borrowing, can affect the money supply.
  - **Financial Innovation:**
    - ☞ New Financial Products: Introduction of new financial instruments can change the size and composition of the money supply.
  - **Effects of Money Supply on the Economy:**
    - ☞ Increase in money supply lowers interest rates.
    - ☞ More money in consumers' hands leads to higher spending.
    - ☞ Increased spending drives businesses to order more raw materials and boost production.
    - ☞ Higher business activity increases demand for labor.
    - ☞ A decline in money supply has the opposite effect.
    - ☞ Changes in money supply impact price levels and inflation.
    - ☞ Significant effects are also observed on inflation and interest rates.
  - **Money Multiplier**
    - ☞ It refers to the amount of broad money banks create with each rupee of reserves or base money they hold. Reserves are the deposits banks must keep with the RBI and not lend out.
    - ☞ It is calculated as Money Multiplier =  $1/r$  (where  $r$  is the reserve ratio) or as the ratio of M3 to M0 ( $M3/M0$ ).

Money is crucial for economic transactions and the effective management of the money supply, influenced by central banks and public preferences, is essential for controlling inflation, interest rates, and promoting economic growth.

# 3 CHAPTER

# Monetary Policy

It is a macroeconomic tool employed by the Central Bank to control the money supply and achieve specific economic objectives. It involves the use of monetary instruments to regulate credit availability in the market, aligning with broader economic policy goals. The major objectives of monetary policy are:

- Promote economic growth by ensuring adequate liquidity for investment.
- Control inflation and maintain price stability.
- Stabilize exchange rates for international trade.
- Balance savings and investment through interest rate management.
- Foster job creation by supporting a favourable economic environment.

## Classification of Monetary Policy

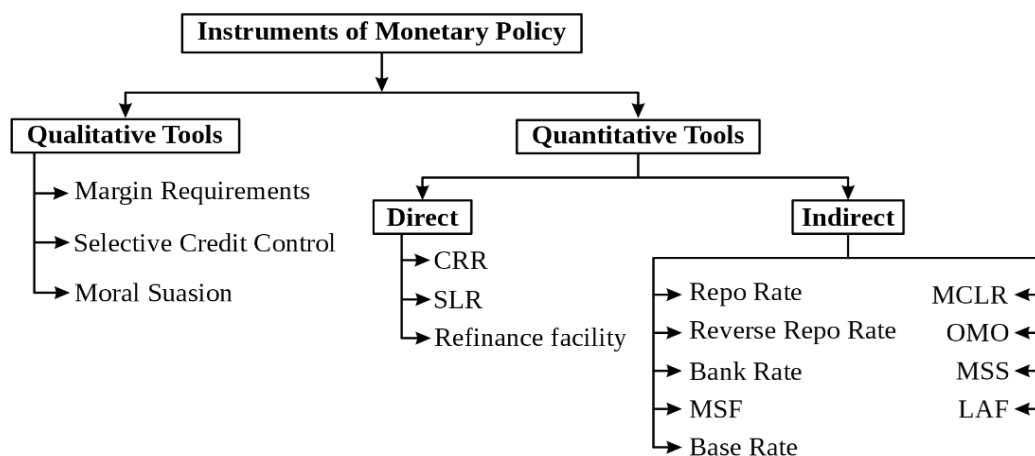
### 1. Expansionary Monetary Policy

- ✓ Done with the aim to increase money supply to stimulate economic growth during slowdown or recessions like during the Global financial crisis of 2008.
- ✓ Also Known as the Dovish Policy or the accommodative stance.
- ✓ Key Features:
  - Lower interest rates (Repo Rate, Bank Rate, SLR, MSF).
  - Injects liquidity into the banking system, encouraging more lending.
  - Boosts aggregate demand and investment.

### 2. Contractionary Monetary Policy

- ✓ Done with the aim to reduce money supply to control inflation or when the economy is overheated like done by the RBI after the covid inflationary period.
- ✓ Also Known as the Hawkish Policy.
- ✓ Key Features:
  - Higher interest rates (Repo Rate, Bank Rate, SLR, MSF).
  - Absorbs excess liquidity, reducing credit for spending and investment.
  - Limits aggregate demand to stabilize inflation.

## Various Tools of Monetary Policy



### 1. Quantitative Tools

- ✓ **Repo Rate:** The repo rate is the interest rate at which the RBI provides loans to commercial banks. It serves as a crucial monetary policy instrument for controlling inflation, managing liquidity, and promoting economic growth.

- 
- ✓ **Reverse Repo Rate:** The reverse repo is the interest rate the RBI pays to commercial banks for parking their excess liquidity with it. It is considered as the opposite of repo rate.
  - ✓ **Base Rate:** The base rate is the minimum rate set by the Reserve Bank of India, below which banks cannot lend to their customers.
  - ✓ **Bank Rate:** The bank rate is the interest rate charged by a central bank when lending to commercial banks.
  - ✓ **Marginal Standing Facility (MSF):** MSF is a penal interest rate at which banks can borrow from the RBI when they have no other borrowing options. Banks pledge government securities at a rate higher than the repo rate to access quick cash within a day.
  - ✓ **Marginal cost of funds-based lending rate (MCLR):** MCLR is the minimum interest rate at which a bank can lend, determined by four factors: marginal cost of funds, CRR carry cost, operating cost and tenor premium.
  - ✓ **Open Market Operations (OMO):** It is the buying and selling of government securities in the open market by the RBI.
    - In case of excess liquidity RBI conducts sale of securities to suck out rupee liquidity.
    - In case of low liquidity RBI buys securities from the market to pour in money and boost the economy.
  - ✓ **Market Stabilisation Scheme (MSS):** It is a tool used by the RBI to manage money supply by removing excess liquidity from large capital inflows, through the issuance of dated government securities and Treasury bills.
  - ✓ **Liquidity Adjustment Facility (LAF):** It is a monetary policy tool used by the RBI to manage liquidity in the banking system, either injecting or absorbing it. It was introduced following the 1998 Narasimhan Committee on Banking Sector Reforms.
  - ✓ **LAF Corridor:** It has the Marginal standing facility (MSF) rate as its upper bound (ceiling) and the Standing deposit facility (SDF) rate as the lower bound (floor), with the policy repo rate in the middle of the corridor.
  - ✓ **Standing Deposit Facility:** The SDF is the rate at which the Reserve Bank accepts uncollateralized overnight deposits from all LAF participants. Besides managing liquidity, it also serves as a financial stability tool. Set 25 basis points below the policy repo rate, the SDF rate replaced the fixed reverse repo rate as the floor of the LAF corridor in April 2022.
  - ✓ **Cash Reserve Ratio (CRR):** It is the minimum percentage of a bank's deposits that must be kept with the RBI in cash. The RBI does not pay interest on CRR deposits and has the flexibility to set the rate based on economic conditions.
    - **Increased CRR:** Reduces money supply as banks have less to lend.
    - **Decreased CRR:** Increases money supply as banks have more to lend.
  - ✓ **Incremental Cash Reserve Ratio (ICRR):** The ICRR is similar to the CRR, where banks must set aside a portion of their funds with the RBI without earning interest. However, the ICRR can be imposed alongside the CRR, and it carries a different interest rate.
  - ✓ **Statutory Liquidity Ratio (SLR):** It is the percentage of Net Demand and Time Liabilities (NDTL) that commercial banks must maintain in cash, gold, or government securities. Unlike CRR, SLR is not deposited with the RBI.
    - **Increased SLR:** Reduces money supply as banks have less to lend.
    - **Decreased SLR:** Increases money supply as banks have more to lend.

## 2. Qualitative Tools

- ✓ **Margins Requirements:** Margin is the difference between the value of securities and the loan granted. To control credit flow, the RBI sets high margins for specific sectors, reducing loans to those sectors.
- ✓ **Selective Credit Control:** RBI sets limits on loans banks can grant, tightening lending to the public.

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- ✓ **Moral Suasion:** RBI uses persuasion to encourage banks to follow its policies and maintain desired money supply levels.
  - ✓ **Direct Action:** RBI may take direct actions, such as refusing to rediscount bills or charging penalties, if banks don't cooperate with its objectives.

## Unconventional Monetary Policy Tools

- **Zero Interest Rate Policy (ZIRP):** Under a ZIRP, the central bank keeps short-term interest rates near zero to stimulate borrowing and investment. However, this can result in a liquidity trap, where both businesses and individuals are reluctant to spend, even with cheap credit available.
- **Negative Interest Rate Policy (NIRP):** NIRP involves setting nominal interest rates below zero to encourage spending and investment rather than the accumulation of cash. Countries such as Japan and Sweden have implemented this policy to boost economic activity.
- **Helicopter Money:** This unconventional approach entails the government directly increasing the money supply, usually through increased spending or tax cuts, to stimulate economic demand.

### **DID YOU KNOW**

Taylor's Rule advises the central bank on adjusting interest rates to manage inflation and promote economic growth. It suggests raising interest rates when inflation is high or actual GDP exceeds potential GDP, and lowering rates when inflation is low or actual GDP is below potential GDP.



## Operation Twist

- Operation Twist is a type of Open Market Operation conducted by the RBI. It involves:
  - ✓ Selling short-term government securities to raise funds.
  - ✓ Using those funds to purchase long-term government securities.
- The goal of Operation Twist is to flatten the yield curve by increasing the prices and lowering the yields of long-term securities, while simultaneously raising the supply of short-term securities, which lowers their prices and increases their yields. This strategy helps to adjust the difference in interest rates between short-term and long-term bonds.
- **Influence on Long-Term Bond Yields and Interest Rates:**
  - ✓ Operation Twist aims to reduce long-term interest rates (bond yields) without affecting short-term rates. By purchasing long-term bonds, the central bank increases demand, raising bond prices and lowering yields, as they move inversely.
- **Benefits of Lower Long-Term Yields:**
  - ✓ **Lower Borrowing Costs:** Reduced yields make long-term borrowing cheaper for businesses and households.
  - ✓ **Encouragement of Investment:** Lower borrowing costs stimulate investment and economic growth.
  - ✓ **Weakened Currency:** Lower rates can lead to currency depreciation, boosting exports.

## Sterilization

- Sterilization is the process used by central banks, including the RBI, to manage the impact of foreign exchange interventions on domestic money supply and control inflation. It is mainly done through open market operations.
- Key tools used by the RBI for sterilization:
  - ✓ Open Market Operations (OMO): Buying or selling government securities to adjust liquidity.
  - ✓ MSS Bonds: Issuing bonds to absorb excess liquidity.
- Actions based on currency movements:
  - ✓ Rupee Depreciation: RBI sells dollars to stabilize the currency.
  - ✓ Rupee Appreciation: RBI buys dollars to control excessive appreciation.

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## Quantitative Easing

- It is when the Central Bank buys securities from the open market to lower interest rates and boost the money supply.
- This aims to increase bank reserves, enhance liquidity, and encourage lending and investment.

## Monetary Policy Committee (MPC)

- The MPC was established through an agreement between the government and RBI to implement an inflation-targeting policy. The RBI Act, 1934, was amended by the Finance Act, 2016, to create a statutory framework for the MPC, which consists of six members as per Section 45ZB.
- **Composition:**
  - ✓ Six members: RBI Governor (Chairperson), Deputy Governor in charge of monetary policy, one RBI Board official and three government representatives.
  - ✓ External members serve for four years.

### **45ZC: Eligibility and Selection of Members appointed by the Central Government**

The **Members of the Monetary Policy Committee** referred to in section 45ZB shall be appointed by the **Central Government** from amongst persons of ability, integrity and standing, having knowledge and experience in the field of economics or banking or finance or monetary policy.

### **45ZD. Terms and conditions of appointment of Members of Monetary Policy Committee:**

The Members of the Monetary Policy Committee appointed under section 45ZB shall hold office for a period of four years and shall not be eligible for re-appointment.

- **Meetings:**
  - ✓ Quorum: Four members, including the Governor or Deputy Governor.
  - ✓ Decisions made by majority vote; in case of a tie, the RBI Governor casts the deciding vote.
- **Tenure:**
  - ✓ External members serve a four-year term.
  - ✓ RBI Governor and Deputy Governor serve ex-officio.
- **Function and Role:**
  - ✓ Main task: Set the repo rate to control inflation within the target range (currently 4% +/- 2%). Decisions are binding on the RBI.
  - ✓ Assisted by the RBI's Monetary Policy Department in policy formulation.
  - ✓ RBI monitors inflation data (based on CPI) every month.
  - ✓ If inflation goes above 6%, RBI raises interest rates to make borrowing costlier – people spend less and prices cool down
  - ✓ If inflation goes below 2%, RBI cuts interest rates to make borrowing cheaper – people spend more and prices rise.
  - ✓ The Monetary Policy Committee (MPC) meets every two months to decide these rate changes.
  - ✓ The MPC is required to meet at **least four times** in a year.
  - ✓ If RBI fails to control inflation (between 2% and 6%) for 3 consecutive months, then it writes report to government explaining the reasons behind failure.

## **Monetary Policy Process**

- **Meeting schedule:** The schedule of monetary policy voting/decision meetings for the entire fiscal year is announced in advance.
- **Meeting notice:** Ordinarily, **not less than fifteen days' notice** is given to members for meetings of the Committee.
- **Meeting duration:** The duration of monetary policy meetings is as decided by the Committee.

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- **The MPC Resolution:** The Bank publishes, after the conclusion of every meeting of the MPC, the resolution adopted by the said Committee. The resolution includes the MPC's decision on the policy repo rate.
  - **Minutes of the MPC meeting:** On the 14th day after every meeting of the MPC, the minutes of the proceedings of the MPC are published.
  - **The Monetary Policy Report:** Once in every six months, the Reserve Bank publishes the Monetary Policy Report.

## Importance of Monetary Policy

1. **Price Stability** – Maintains inflation within the  $4\% \pm 2\%$  target to ensure macroeconomic stability.
2. **Inflation Expectation Anchoring** – Stabilizes public and investor expectations to protect real incomes.
3. **Growth Management** – Uses interest rate tools to balance economic growth and inflation.
4. **Liquidity Regulation** – Manages systemic liquidity through LAF, OMO, CRR, etc.
5. **Credit Flow Facilitation** – Influences lending rates and ensures credit to productive sectors.
6. **Financial Stability** – Prevents asset bubbles and systemic financial risks.
7. **Exchange Rate Stability** – Moderates currency volatility and imported inflation pressures.
8. **Policy Credibility** – Strengthens institutional transparency via the MPC framework.

## Challenges in Monetary Policy

1. **Supply-Side Inflation** – Repo rate tools are ineffective against food and fuel shocks.
2. **Weak Transmission Mechanism** – Banking rigidities delay policy rate pass-through.
3. **Growth–Inflation Trade-off** – Tight policy controls inflation but may slow growth.
4. **Fiscal Dominance** – High government borrowing complicates policy independence.
5. **Global Spillovers** – External tightening cycles trigger capital outflows and currency pressure.
6. **High Food Weight in CPI** – Large food component reduces effectiveness of rate adjustments.
7. **Informal Economy Constraints** – Limited formal credit penetration weakens policy reach.
8. **Liquidity Management Complexity** – Balancing inflation control with financial stability is challenging.

## Inflation Targeting

- Inflation Targeting is a central banking policy focused on adjusting monetary policy to meet a specific annual inflation rate. It is based on the idea that long-term economic growth is best achieved through price stability, which is maintained by controlling inflation. There are two types of Inflation Targeting:
  - ✓ **Strict Inflation Targeting:** The central bank prioritizes keeping inflation as close to the target as possible, with no focus on other factors.
  - ✓ **Flexible Inflation Targeting:** The central bank aims to maintain inflation within the target range while also considering factors like interest rates, exchange rates, output, and employment.
- The Urjit Patel Committee established the inflation targeting framework, setting an inflation target of (4% +/- 2%) in collaboration with the government to strengthen monetary policy credibility and anchor inflation expectations.

## Monetary Policy Transmission

- It is the process through which the Central Bank's actions, such as changing the Repo Rate, influence inflation and economic growth.
- It includes the impact of policy rate changes on financial markets and, ultimately, on businesses and households.

India's monetary policy, managed by the RBI, focuses on controlling inflation, stabilizing the economy, and fostering growth. The RBI uses tools like the repo rate and open market operations to manage interest rates and liquidity.