RBI to Discontinue I-CRR

For Prelims: RBI to discontinue I-CRR, Incremental Cash Reserve Ratio, Statutory Liquidity Ratio, **Monetary Policy**, **Reserve Bank of India.**

For Mains: RBI to Discontinue I-CRR, its Need and Implications.

Source: TH

Why in News?

Recently, the Reserve Bank of India (RBI) announced that it would discontinue the **Incremental Cash Reserve Ratio (I-CRR)** in a phased manner.

- The central bank will release the amount that banks have maintained under I-CRR in stages.

How Will the RBI Implement Discontinuation of I-CRR?

- The discontinuation of the I-CRR will be **implemented in stages** to ensure a smooth transition and **prevent sudden shocks to the system's liquidity.**
    - In the first and second stages of the I-CRR reversal, 25 % of each of the Banks' impounded funds will be released. The remaining 50% of the balance will be released in the third stage.
- This measured approach aims to ensure that **banks have sufficient liquidity to meet increased credit demand** during the **upcoming festival season.**

What is I-CRR?

- **Background:**
    - On 10th August 2023, following the announcement of the **monetary policy** and the **demonetization** of Rs 2000 notes, the RBI declared that banks would be required to maintain an **Incremental Cash Reserve Ratio (I-CRR)** of 10% on the increase in their **Net Demand and Time Liabilities (NDTL).**
        - **NDTL** is the **difference** between the **sum of demand and time liabilities** (deposits) of a bank (with the public or the other bank) and the deposits in the form of **assets held by the other banks.**
    - Stated that it would review it in September 2023, or earlier.
- **Purpose of Introducing I-CRR:**
    - The RBI introduced the I-CRR as a temporary measure to **manage excess Liquidity** in the banking system.
        - Several **factors contributed** to the **Surplus Liquidity**, including the demonetisation of Rs 2,000 banknotes.
    - RBI's surplus transfer to the government, increased **government spending, and capital inflows.**
    - This liquidity surge had the **potential to disrupt price stability and financial stability,**

necessitating efficient liquidity management.
- **Impact of I-CRR on Liquidity Conditions:**
    - The I-CRR measure would absorb over **Rs 1 lakh crore of excess liquidity** from the banking system.
    - As a result of the I-CRR mandate, the banking system's **liquidity temporarily turned into a deficit on 21st August 2023,** exacerbated by **outflows related to Goods and Services Tax (GST)** and central bank intervention to stabilize the rupee.
    - However, liquidity conditions returned to Liquidity from the system.

What is the Cash Reserve Ratio (CRR)?

- **About:**
    - The percentage of cash required to be kept in reserves as against the bank's total deposits, is called CRR.
    - All banks in India (all Scheduled Commercial Banks (SCBs) (including RRBs), Small Finance Banks (SFBs), Payments Banks, Primary (Urban) Co-operative Banks (UCBs), State Co-operative Banks (StCBs) and District Central Co-operative Banks (DCCBs)) have to maintain CRR with RBI.
        - Every co-operative bank (not being a scheduled co-operative bank) and Local Area Banks shall maintain CRR with itself or with the RBI.
    - Banks can't lend the CRR money to **corporates or individual borrowers,** banks can't use that money for investment purposes, and **Banks don't earn any interest on that money.**

Note

Primary Agricultural Credit Societies are not covered by the Banking Regulation Act of 1949 and are not regulated by the RBI.

- **Need to Have Reserve cash with the RBI:**
    - Since a part of the bank's deposits is with the RBI, it ensures the **security of the amount in case of any emergencies.**
    - The cash is **readily available when customers want** their deposits back.
    - CRR helps in keeping **inflation under control.** If there is a threat of high inflation in the economy, RBI increases the CRR, so that banks need to keep more money in reserves, effectively reducing the amount of money that is available to the banks.
        - This curbs the **excess flow of money in the economy.**
    - When there is a need to pump funds into the market, the RBI lowers the CRR rate, which in turn, helps the banks provide loans to a large number of businesses and industries for investment purposes. **Lower CRR also boosts the growth rate of the economy.**
    - The CRR and other monetary tools require every commercial bank to maintain but not the NBFC.

Why is RBI using I-CRR in the Case of Demonetisation?

- RBI has chosen to implement I-CRR in the case of a **sudden influx of liquidity, such as during demonetization.**
    - **RBI used I-CRR in November 2016,** after the **demonetization of Rs 500 and Rs 1,000 banknotes.**
- It allows the RBI to **address the issue without affecting other aspects of monetary policy.** This precision can be crucial, especially during **unique situations like demonetization.**
- The I-CRR **can be implemented relatively quickly.** When there is a sudden surge in liquidity due to a large-scale event like the **return of demonetized currency notes,** the central bank may need a tool that can be put into effect promptly.
- The **I-CRR is typically intended to be a temporary measure.** It can be introduced when there is a need to absorb excess liquidity temporarily and can be phased out once the liquidity situation

stabilizes.

- But on the other hand **Other tools such as Repo Rate, Statutory Liquidity Ratio (SLR) etc may have rather long term and slower impact on liquidity.**

What are the Monetary Policy Instruments Available to the RBI?

- **Qualitative:**
    - **Moral Suasion:** This is a **non-binding technique where the RBI uses persuasion and communication** to influence banks' lending and investment behavior.
    - **Direct Credit Controls:** These are measures that involve **regulating the flow of credit to specific sectors or industries.** The RBI can issue directives on lending to certain sectors or set credit limits to achieve policy objectives.
    - **Selective Credit Controls:** These are **more specific than direct credit controls and target particular types of loans, such as consumer credit,** to control demand in specific areas of the economy.
- **Quantitative:**
    - **Cash Reserve Ratio (CRR):** CRR is the proportion of a **bank's deposits that it must keep as reserves with the RBI** in the form of cash. By adjusting the CRR, the RBI can control the amount of funds available for lending by banks.
    - **Repo Rate:** The repo rate is the **interest rate at which the RBI lends money to commercial banks for the short term.** A change in the repo rate can influence banks' borrowing costs and, subsequently, their lending rates.
    - **Reverse Repo Rate:** The reverse **repo rate is the interest rate at which banks can park their excess funds with the RBI.** It provides a floor for short-term interest rates and helps manage liquidity.
    - **Bank Rate:** The bank rate is the rate at which the **RBI provides long-term funds to banks and financial institutions.** It influences interest rates in the long-term money market.
    - **Open Market Operations (OMOs):** OMOs involve the **buying or selling of government securities by the RBI in the open market.** This action affects the money supply and liquidity in the banking system.
    - **Liquidity Adjustment Facility (LAF)**: The LAF includes the repo rate and the reverse repo rate and is used by banks for their short-term liquidity needs. It **helps the RBI manage daily liquidity conditions.**
    - **Marginal Standing Facility (MSF):** MSF is the rate at which **banks can borrow overnight funds from the RBI against the collateral of government securities**. It serves as a secondary source of funding for banks.
    - **Statutory Liquidity Ratio (SLR):** SLR is the percentage of a bank's net demand and time liabilities (NDTL) that it must maintain in the form of approved securities.

UPSC Civil Services Examination, Previous Year Question (PYQ)

<u>Prelims</u>

Q1. When the Reserve Bank of India announces an increase of the Cash Reserve Ratio, what does it mean? (2010)

(a) The commercial banks will have less money to lend

(b) The Reserve Bank of India will have less money to lend

(c) The Union Government will have less money to lend

(d) The commercial banks will have more money to lend

Ans: (a)

Q2. Which of the following terms indicate a mechanism used by commercial banks for providing credit to the government? (2010)

(a) Cash Credit Ratio

(b) Debt Service Obligation

(c) Liquidity Adjustment Facility

(d) Statutory Liquidity Ratio

Ans: (d)

Q3. With reference to Indian economy, consider the following: (2015)

1. Bank rate
2. Open market operations
3. Public debt
4. Public revenue

Which of the above is/are component/ components of Monetary Policy?

(a) 1 only
(b) 2, 3 and 4
(c) 1 and 2
(d) 1, 3 and 4

Ans: C

Q4. In the context of Indian economy, 'Open Market Operations' refers to (2013)

(a) borrowing by scheduled banks from the RBI
(b) lending by commercial banks to industry and trade
(c) purchase and sale of government securities by the RBI
(d) None of the above

Ans: C

Q5. In the context of Indian economy, which of the following is/are the purpose/purposes of 'Statutory Reserve Requirements'? (2014)

1. To enable the Central Bank to control the amount of advances the banks can create
2. To make the people's deposits with banks safe and liquid
3. To prevent the commercial banks from making excessive profits
4. To force the banks to have sufficient vault cash to meet their day-to-day requirements

Select the correct answer using the code given below:

(a) 1 only
(b) 1 and 2 only
(c) 2 and 3 only
(d) 1, 2, 3 and 4

Ans: (a)

Mains

Q. Do you agree with the view that steady GDP growth and low inflation have left the Indian economy in good shape? Give reasons in support of your arguments. **(2019)**

PDF Refernece URL: https://www.drishtiias.com/printpdf/rbi-to-discontinue-i-crr