

FOUR IMPORTANT MONETARY TERMS (PART 2)



**A Quick Guide To
Four Important Monetary Terms
(Part 2)**
– By Prof. *Simply Simple*



FOUR IMPORTANT MONETARY TERMS (PART 2)



- ❑ In the last edition, we looked at repo rate & statutory liquidity ratio (SLR) and what these measures signify for the larger economy and consumers.
- ❑ In this edition, we will try to understand the concepts of Cash Reserve Ratio (CRR) and Market Stabilization Scheme (MSS).

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The Cash Reserve Ratio

- ❑ **CRR is a bank regulation that sets the minimum reserves each bank must hold to customer deposits and notes.**
- ❑ **These reserves are designed to satisfy withdrawal demands, and would normally be in the form of currency stored in a bank vault (vault cash), or with a central bank.**



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Recently...

- ❑ The RBI has been selling US dollars to stem the fall of the Indian Rupee, which has fallen 27% against the US Dollar since January.
- ❑ For every dollar the RBI sells an equivalent amount of rupees is sucked out from the system.
- ❑ In other words, liquidity will remain in the system if RBI stops selling dollars and allows the rupee to depreciate.



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An Update!

- ❑ **The CRR has been cut by 100 basis points in two stages. With this, the RBI has brought down the CRR from 9% to its January 2007 level of 5.5%.**
- ❑ **Now, the outstanding deposit portfolio of the Indian banking industry is around Rs 34.69 trillion.**
- ❑ **This means a 100 basis points cut in CRR releases around Rs. 34,690 crore into the system.**
- ❑ **This includes certain other liabilities, besides deposits.**



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Now...

- ❑ Banks can use this money to lend. A cut in CRR also increases banks' income. RBI does not pay any interest on the cash balance kept with it.
- ❑ Banks can earn 13.5-14% from the freed-up money if they lend to corporate customers with good ratings or around 7.5% if they invest in government securities.
- ❑ Theoretically, the level of CRR can be brought down to zero. This means, RBI can at best release Rs. 2.2 trillion into the financial system to ease the liquidity constraint.



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However...

- ❑ This situation can also be achieved if the supply of dollars increases with foreign institutional investors (FIIs) buying Indian equities and local firms borrowing overseas.
- ❑ The combination of adequate liquidity and low policy rate can bring the borrowing cost down for firms and individuals.



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Market Stabilization Scheme

- ❑ Till the time the rupee was rising against the dollar, the RBI was aggressively buying dollars from the market to stem the rise of the local currency.
- ❑ This is because a strong local currency hurts exporters' interest as their income, in rupee terms, comes down.
- ❑ For every dollar RBI bought, an equivalent amount of rupees flowed into the system and that, in turn, was sucked out by bonds, floated under the market stabilization scheme.



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Now...

- ❑ Thus there was a liquidity overhang that was caused by the inflow of dollars. This forced the Government to mop up the rupees by creating the MSS bonds.
- ❑ MSS was introduced by way of an agreement between the Government and the Reserve Bank of India (RBI) in early 2004.
- ❑ Under the scheme, RBI issues bonds on behalf of the Government and the money raised under bonds is impounded in a separate account with RBI.
- ❑ The money does not go into the Government account.



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Recent Update!

- ❑ The outstanding MSS bonds in RBI book are worth Rs.1.74 trillion and out of this, dated securities account for Rs.1.35 trillion with the rest being short-term treasury bills.
- ❑ The RBI plans to buy back part of the MSS bonds to generate cash for banks which can reinvest them in government bonds that will be floated between now and March 2009.
- ❑ In other words, banks will not be required to dip into their deposit pool to buy Government bonds.



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Therefore...

- ❑ **The buy back will help the banks generate liquidity and the Government see its borrowing programme through.**
- ❑ **However, the response of banks to the buy back programme will depend on the price of MSS bonds.**
- ❑ **Since interest rates can only go down in coming days, banks may find staying invested in MSS bonds makes business sense.**



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To Sum Up

- ❑ **The Cash Reserve Ratio determines the proportion of bank deposits that is to be kept with the RBI.**
- ❑ **The Market Stabilization Scheme was introduced by way of an agreement between the government and the RBI in early 2004.**
- ❑ **Under the scheme, RBI issues bonds on behalf of the government and the money raised under bonds is impounded in a separate account with RBI. The money does not go into the government account.**



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Hope you have now understood the concept of **Cash Reserve Ratio (CRR)** and **Market Stabilization Scheme (MSS)**.

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