Surplus Liquidity

For Prelims: Repo rate, reverse rapo rate, monetary policy committee, concepts related to inflation

For Mains: Impact of increased liquidity, factors leading to increase in liquidity in the market

Why in News?

Recently, the **net liquidity in the banking system in India increased to Rs 2.59 lakh crore on June 4, 2023.** However, the surplus liquidity in the banking system is likely to decline to around Rs 1.5 lakh crore over the next few days from the current level of Rs 2.1 lakh crore.

- The net liquidity in the banking system is represented by the amount of money absorbed by the **Reserve Bank of India (RBI)** from the system.

What is Surplus Liquidity?

- **About:**
    - Surplus liquidity occurs where **cashflows into the banking system persistently exceed withdrawals of liquidity** from the market by the central bank.
        - Liquidity in the banking system refers to readily available cash that banks need to meet short-term business and financial needs.
- **Causes of Increased Liquidity:**
    - Advance tax and **goods and services tax (GST)** payments,
    - The deposit of withdrawn Rs 2,000 notes,
    - Redemption of government bonds,
    - Higher government spending,
    - The sale of dollars by the RBI to defend the rupee from depreciation.
- **Impact of Increased liquidity:**
    - It may lead to increased levels of **inflation.**
    - Interest rates in the market will remain low.
- **RBI's Measures:**
    - The RBI takes action if liquidity levels deviate from its comfort range.
    - The RBI, under its **Liquidity Adjustment Facility,** infuses liquidity in the banking system via repos and sucks it out using reverse repos after assessing liquidity conditions.
        - The RBI also uses a 14-day **variable rate repo and/or reverse repo operation**.

What are the Tools Used by RBI to control Money Supply?

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Quantitative Instruments	Basis	Qualitative Instruments
These are the instruments of monetary policy that affect overall supply of money/credit in the economy.	**Meaning**	These instruments are used to regulate the direction of credit.
Traditional methods of control	**Alternative Name**	Selective methods of control
(*i*) Bank rate (*ii*) Repo Rate (*iii*) Reverse Repo Rate (*iv*) Open market operation (*v*) Cash reserve ratio (*vi*) Statutory liquidity ratio	**Instruments**	(*i*) Marginal requirement (*ii*) Moral suasion (*iii*) Selective credit control

Various Instruments of Monetary Policy	
Repo Rate:	▪ The interest rate at which the Reserve Bank **provides overnight liquidity** to banks **government and other approved securities** under the **liquidity adjustment fac**
Reverse Repo Rate:	▪ The interest rate at which the **Reserve Bank absorbs liquidity,** on an overnight ba **of eligible government securities under the LAF.**
Liquidity Adjustment Facility (LAF):	▪ The LAF **consists of overnight as well as term repo auctions.** ▪ The aim of term repo is to help develop the **interbank term money market,** which benchmarks for pricing of loans and deposits, and hence improve transmission of mo ▪ The RBI also conducts variable interest rate reverse repo auctions, as necessitated ur
Marginal Standing Facility (MSF):	▪ A facility under which scheduled commercial banks can borrow additional amount of Bank by dipping into their Statutory **Liquidity Ratio (SLR)** portfolio up to a limit at a ▪ This provides a safety valve against unanticipated liquidity shocks to the banking sys
Corridor:	▪ The MSF rate and reverse repo rate determine the **corridor for the daily movemen** **money rate.**
Bank Rate:	▪ It is the rate at which the RBI is ready to buy or rediscount bills of exchange or other published under **Section 49 of the RBI Act, 1934.** ▪ This rate has been aligned to the MSF rate and, therefore, changes automatically as a alongside policy repo rate changes.
Cash Reserve Ratio (CRR):	▪ The average daily balance that a bank is required to maintain with the Reserve Bank **demand and time liabilities (NDTL)** that the Reserve Bank may notify from time t
Statutory Liquidity Ratio (SLR):	▪ The share of NDTL that a bank is required to maintain in safe and liquid assets, such **securities, cash and gold.** ▪ Changes in SLR often influence the availability of resources in the banking system for
Open Market Operations (OMOs):	▪ These include both, outright purchase and sale of government securities, for injection respectively.
Market Stabilisation Scheme (MSS):	▪ This instrument for monetary management **was introduced in 2004.** ▪ Surplus liquidity of a more enduring nature arising from large capital inflows is absorb government securities and treasury bills. ▪ The cash so mobilised is **held in a separate government account with the RBI.**

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims:

Q. The money multiplier in an economy increases with which one of the following?(2021)

(a) Increase in the Cash Reserve Ratio in the banks
(b) Increase in the Statutory Liquidity Ratio in the banks
(c) Increase in the banking habit of the people
(d) Increase in the population of the country

Ans: (c)

Exp:

- In macroeconomics, the money multiplier is important because it determines the money supply.
- Money multiplier shows the magnified change in the money supply that results from the infusion of additional reserves into the banking system.
- The most basic multiplier used in computing the multiplier effect is calculated as change in income / change in spending.
- The money multiplier effect can be seen in a country's banking system. An increase in bank lending should translate to an expansion of a country's money supply. Thus, the money multiplier in an economy increases with an increase in the banking habits of the people.
- **Therefore, option (c) is the correct answer.**

Mains

Question: Do you agree with the view thatsteady GDP growth and low inflation have left the Indian economyin good shape? Give reasons in support of your arguments. **(2019)**

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