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Indian Economy

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Compiled by Arvind KrS

57	11	497	372	186
CHAPTERS	UNITS	PYQS 2011–26, PRELIMS AND MAINS	ORIGINAL DIAGRAMS AND CHARTS	PRACTICE MCQS WITH ANSWERS

MILESTONES OF THE INDIAN ECONOMY

1951	1969	1991	2016	2017	2026
First Five Year Plan	Banks nationalised	LPG reforms	IBC and the MPC	GST rolled out	New GDP and CPI bases

IN THIS BOOK

I Foundations of the Economy

II Money, Banking and Monetary Policy

III Financial Markets, Insurance and Pensions

IV Public Finance

V External Sector

VI International Economic Organisations

VII Agriculture Economy and Food Management

VIII Industry, Services and Labour

IX Infrastructure and Investment Models

X Employment, Poverty and Inclusive Growth

XI Revision Banks and Practice

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Updated to November 2026

LOTUSARISE IAS

Indian Economy for UPSC

Notes for UPSC Civil Services Preliminary Examination and Mains General Studies Paper III

2027 Edition · Compiled November 2026 · Compiled by Arvind KrS

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Foundations of the Economy

How an economy works from first principles: national income and the new GDP series, growth and development, inflation and how prices and output are measured, planning and NITI Aayog, and the economic systems behind the 1991 reforms.

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01 How an Economy Works: Basic Concepts
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07 Economic Systems and the 1991 Reforms
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INDIAN ECONOMY · PRELIMS · GS PAPER III

How an Economy Works: Basic Concepts

On 27 February 2026 the National Statistics Office (NSO) reset its yardstick: **gross domestic product (GDP)**, the value of the goods and services produced in a year, now uses 2022-23, not 2011-12, as its base (reference) year. On 31 August 2026 it put GDP for 2025-26 at about **₹345 lakh crore**, up **7.8%** after removing price rises. Services made over half of it; farms, forests and fisheries under a fifth. Yet the *Periodic Labour Force Survey* (PLFS) for 2025 found that **43%** of India's workers still earn their living in agriculture.

Why do so many workers produce so little of the output? Who decides what a country produces, and how does a rupee spent at a kirana shop return to someone as a wage? Every later chapter of this book rests on the simple tools that answer these questions.

How GDP is measured is explained in Chapter 2, growth and business cycles in Chapter 3, and economic systems and the 1991 reforms in Chapter 7.

SYLLABUS

PRELIMS Economic and Social Development – Sustainable Development, Poverty, Inclusion, Demographics, Social Sector Initiatives, etc

MAINS · GS PAPER III Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment

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01 Scarcity, Choice and Opportunity Cost
02 The Four Factors of Production
03 Microeconomics and Macroeconomics
04 Sectors of the Economy
05 India's Sectoral Shape Today
06 Goods and Services: Key Types
07 Public, Private and Merit Goods
08 Markets, Demand and Supply
09 The Circular Flow of Income
10 Stocks and Flows
11 Economic Systems in Brief
12 Previous Year Questions

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01 Scarcity, Choice and Opportunity Cost

START HERE RAMESH HAS ₹500 AND ONE SUNDAY

Ramesh, a college student in Lucknow, has ₹500 left for the week and one free Sunday. He can buy a new cricket ball and watch a film, or buy two guidebooks and spend the day studying. He cannot do everything, because both his money and his time are limited. Whatever he picks, he gives up the next best option. Countries face the same problem on a giant scale: land, workers, machines and time are limited, but people's wants are not. Economics is the study of how people and societies make such choices.

The word "economics" comes from the Greek *oikonomia*, the management of a household. Today it means the study of how people use **scarce resources** to satisfy **unlimited wants**. In 1932 Lionel Robbins defined it as "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses". An **economy** is the system through which the people of a country (or region) produce, distribute and consume goods and services.

Scarcity means that resources are limited relative to wants, not that they are absent. India has a great deal of land and labour, yet it cannot produce all the roads, hospitals, wheat and smartphones its people want at once. Scarcity forces **choice**, and every choice has a cost.

The Central Problems of an Economy

Every economy, rich or poor, planned or free, must answer the same basic questions:

- **What to produce, and how much?** More food or more cars; more goods for today's consumption or more machines that raise tomorrow's output.
- **How to produce?** With more workers or more machines (labour-intensive or capital-intensive methods); with which technology.
- **For whom to produce?** Who gets how much of the output: the question of distribution, of whether everyone is assured a minimum of food, schooling and health care.

Opportunity Cost and the Production Possibility Frontier

The **opportunity cost** of a choice is the value of the next best alternative given up to make it. When a farmer in Nashik plants onions on a field, the opportunity cost is the grapes or soybean that the same field could have yielded. Economists also call it the **economic cost**.

The **production possibility frontier** (PPF), also called the production possibility curve or transformation curve, shows all the combinations of two goods that an economy can produce when it uses all its resources fully and efficiently with a given technology. Figure 1.1 explains how to read it.

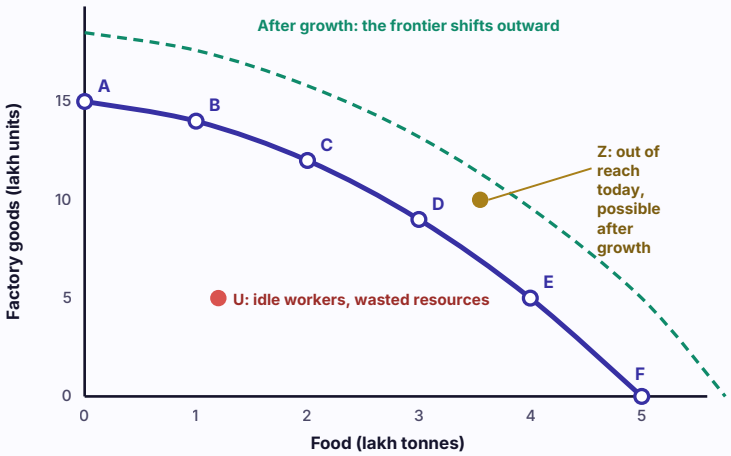
- **On the curve:** resources are fully and efficiently used. Moving along it means getting more of one good only by giving up some of the other.
- **Inside the curve:** some resources are idle or wasted, for example during a recession or a lockdown.
- **Outside the curve:** unattainable with today's resources and technology.

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- **Shape:** the curve usually bows outward because resources are not equally suited to both goods, so each extra unit of one costs more and more of the other (rising opportunity cost).
- **Shifts:** more resources or better technology (the Green Revolution, new machines, a more skilled workforce) push the whole frontier outward; this is **economic growth**. A war or natural disaster that destroys capital pulls it inward.

The Production Possibility Frontier: Choice under Scarcity

With all its land, labour and machines, an imaginary economy can make food, factory goods or a mix of both.



COST OF 1 LAKH TONNES MORE FOOD

A to B	give up 1 lakh units
B to C	give up 2 lakh units
C to D	give up 3 lakh units
D to E	give up 4 lakh units
E to F	give up 5 lakh units

Each extra lakh tonnes of food costs more factory goods, because resources better suited to factories are pulled onto farms. So the frontier bows outward.

On the curve: full use. Inside: waste. Outside: unattainable.

Fig. 1.1 Points A to F use all resources; U wastes some; Z needs growth to push the frontier outward.

WORKED EXAMPLE THE REAL COST OF A YEAR OF FULL-TIME PREPARATION

Priya, a graduate, turns down a job paying ₹30,000 a month to prepare full-time for one year. She spends ₹60,000 on books, test series and travel.

ITEM	AMOUNT
Money actually spent (explicit cost)	₹60,000
Salary given up: ₹30,000 × 12 (implicit cost)	₹3,60,000
Opportunity (economic) cost of the year	₹4,20,000

An accountant would record only ₹60,000; an economist counts the forgone salary too.

PRELIMS TRAP "FREE" GOODS STILL HAVE A COST

When the government provides something free, such as rations, school meals or vaccines, its opportunity cost does **not** become zero. The resources used could have gone elsewhere, and the cost is borne by **taxpayers** instead of the users. The cost is transferred, not removed.

Positive and Normative Economics

Positive economics describes how the economy works and can be tested against facts: "If the price of onions rises, people buy fewer onions." **Normative economics** makes value judgements about what ought to

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be: "The government should cap onion prices." Most policy debates mix the two, so a good answer separates the facts from the judgement.

02 The Four Factors of Production

START HERE WHAT DOES A SAMOSA STALL NEED?

To run a samosa stall outside a railway station you need a spot to stand (land), someone to fry and serve (labour), a kadhai, a gas stove and a cart (capital), and a person who puts it all together and bears the loss if sales are poor (enterprise). Each gets paid from the money customers hand over: the landowner gets rent, the helper gets wages, the person who lent money for the cart gets interest, and the owner keeps the profit.

The inputs used to produce goods and services are called **factors of production**. Economists group them into four:

- **Land:** all gifts of nature, not just soil. It includes farmland, minerals, water, forests and the radio spectrum. Its supply is largely fixed. Reward: **rent**.
- **Labour:** human physical and mental effort, from a farm hand to a software engineer. Reward: **wages** or salaries.
- **Capital:** man-made aids to production: machines, tools, buildings, vehicles and software. Reward: **interest**.
- **Entrepreneurship (enterprise):** the ability to combine the other three, take decisions and bear risk. Reward: **profit**, which is what remains after paying the others and can be negative (a loss).

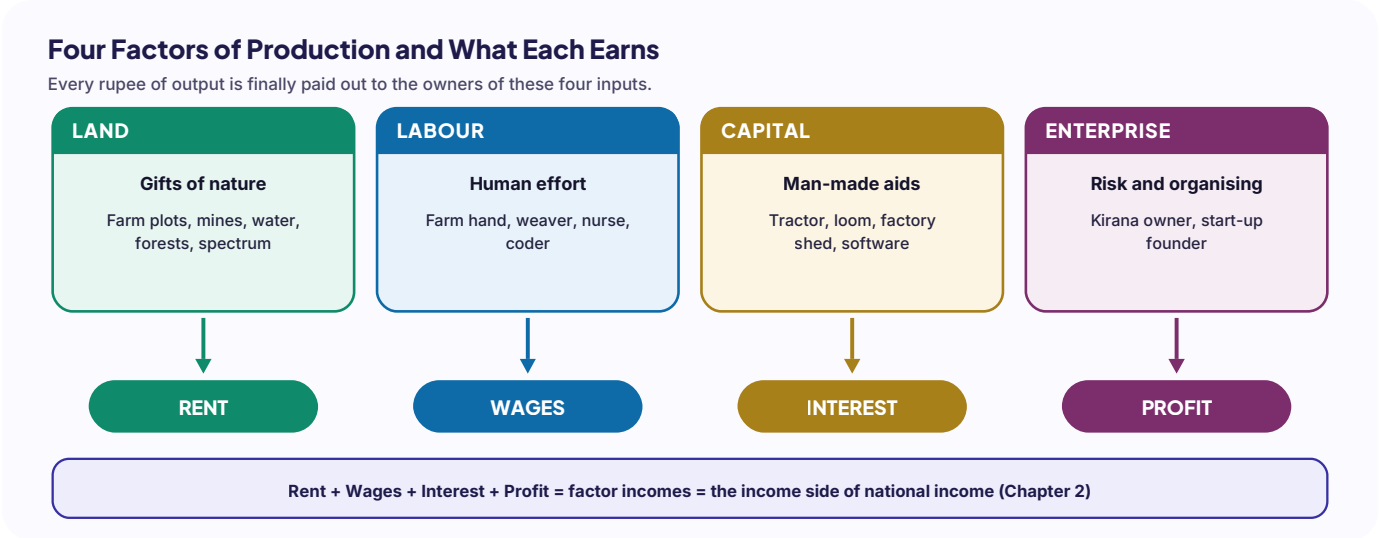


Fig. 1.2 Each factor earns its own kind of income; together these factor incomes add up to national income.

Physical Capital and Human Capital

Physical capital is of two kinds. **Fixed capital** (a plough, a computer, machines, buildings) is used over many years of production. **Working capital** (yarn for a weaver, petrol for a delivery van, other raw materials and the cash to buy them) is used up in one round of production. Firms also invest in **intangible assets**: intellectual

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property, software, brand recognition and customer databases such as client mailing lists; **inventories** (stocks of materials and unsold goods), by contrast, are tangible. **Human capital** is the stock of skill, knowledge and health embodied in people; schooling, training and health care raise it, and so raise the productivity of labour.

Technological progress changes how much each factor can produce. Progress that makes each worker more productive, such as training or better work methods, is called **labour-augmenting**. Progress that makes each unit of capital more productive is **capital-augmenting**: a steel plough in place of a wooden one is a better tool, so the capital itself does more work.

> CONCEPT: WHAT ECONOMISTS CALL INVESTMENT
>
> In everyday speech, buying shares, gold or an insurance policy is "investment". In economics, **investment** means only the creation of new capital goods: a new machine, factory, road or house, plus any rise in inventories. Buying an existing share merely transfers ownership from one person to another; it adds nothing to the economy's capital stock (Chapter 2).

03 Microeconomics and Macroeconomics

Economics is traditionally studied in two branches. **Microeconomics** studies individual decision-makers: a consumer, a firm, the market for one good. It asks how the price of tomatoes is set, or how many workers a textile mill hires. **Macroeconomics** studies the economy as a whole through aggregates such as national income, total employment, the general price level, money supply and the balance of payments.

Macroeconomics emerged as a separate field in the 1930s, when the Great Depression threw millions out of work. John Maynard Keynes, in *The General Theory of Employment, Interest and Money* (1936), argued that total spending in the economy, not just individual markets, decides output and jobs, and that the government can step in when private spending collapses.

BASIS	MICROECONOMICS	MACROECONOMICS
Unit of study	Individual consumer, firm, industry	Whole economy, aggregates
Main price	Price of one good	General price level
Typical questions	Demand for onions; a firm's costs	GDP growth, unemployment, inflation
Also called	Price theory	Income theory
Key names	Adam Smith, Alfred Marshall	J.M. Keynes, Milton Friedman

The two branches are linked: inflation (macro) is the average of millions of individual price changes (micro), and when the Reserve Bank of India (RBI) cuts interest rates (macro), the effect works through the borrowing choices of households and firms (micro).

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04 Sectors of the Economy

START HERE THE JOURNEY OF A COTTON SHIRT

A farmer in Vidarbha grows cotton: that is the primary sector, taking a product straight from nature. A mill in Coimbatore spins and weaves it and a factory in Tiruppur stitches the shirt: the secondary sector, turning raw material into a new good. A truck carries the shirt to Delhi, a bank finances the shop, and a shopkeeper sells it to you: the tertiary sector, which provides services. Every product passes through such a chain.

Economic activities are grouped into **sectors** according to what they do:

- The **primary sector** produces goods by directly using natural resources: agriculture, livestock, forestry, fishing, and mining and quarrying. Because most of its output comes from farms, it is loosely called the agriculture and allied sector, though that official heading leaves out mining.
- The **secondary sector** changes natural products into other forms through manufacturing. In India's national accounts it includes **manufacturing**, **construction**, and **electricity, gas, water supply and other utilities**. It is also called the industrial sector.
- The **tertiary sector** produces services rather than goods: trade, hotels, transport, storage, communication, banking, insurance, real estate, IT, health, education, defence and public administration. It is also called the service sector.

Geographers and management writers split services further. The **quaternary** sector covers knowledge-based work: research and development, information and data services, consultancy. The **quinary** sector covers top-level decision-making and new ideas by senior officials, scientists and executives ("gold collar" work). Official Indian statistics, however, use only the three-sector division.

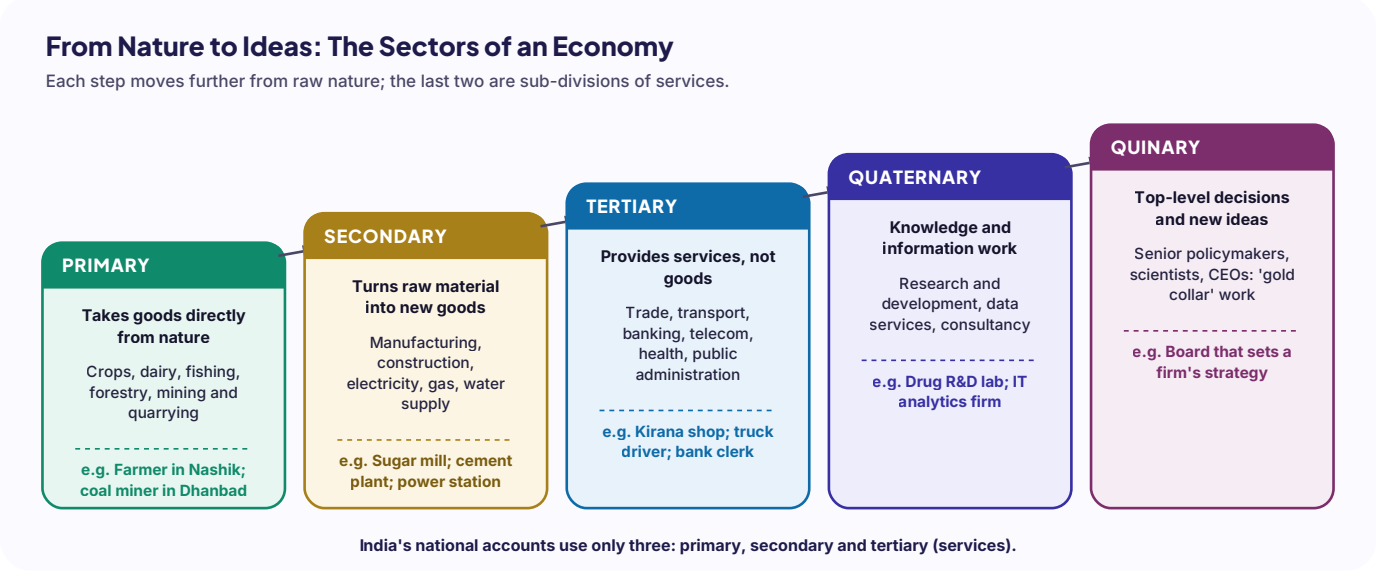


Fig. 1.3 Five levels of economic activity, from extracting natural products to creating new ideas; national accounts group the last three as services.

The sectors depend on one another: a bad cotton crop idles textile mills, and a truckers' strike leaves farmers unable to sell and cities short of vegetables.

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◆ PRELIMS TRAP WHICH SECTOR DOES IT BELONG TO?

- **Mining and quarrying**, including **mineral exploration**, is in the **primary** sector in India's national accounts, though the RBI's agriculture–industry–services split counts mining as industry.
- **Construction** and **electricity, gas and water supply** are **secondary**, not services.
- **Storage** of farm produce in warehouses and **retail trade** are tertiary; **research and development** is quaternary (a part of services).
- A dairy farmer is primary; a dairy plant making cheese is secondary; the milk vendor is tertiary.

Real Sector and Financial Sector

Another useful split is by what is being exchanged. The **real sector** produces actual goods and services: farmers harvesting crops, textile mills turning cotton into fabric, a hospital treating patients. The **financial sector** deals in money and claims on money: banks lending, firms issuing bonds, stock exchanges trading shares. The financial sector exists to move savings to those who invest in the real sector; the Economic Survey 2024-25 warned that when it grows far faster than the real economy it can hurt productivity (Chapter 22).

Organised and Unorganised, Public and Private

Activities can also be classified by the **conditions of work** and by **ownership**:

BASIS	TYPE	MEANING AND INDIAN EXAMPLES
Conditions of work	Organised	Registered with the government; follows labour laws on hours, wages, leave and social security; regular jobs. A bank, a large factory, a government office.
	Unorganised	Small, scattered units largely outside government regulation; jobs are irregular, low-paid and lack social security. Street vendors, small workshops, most farm labour.
Ownership	Public sector	Government owns most assets and provides services: railways, post offices, SBI, NTPC.
	Private sector	Owned by individuals or companies for profit: Tata Steel, Reliance, a kirana shop.

The National Commission for Enterprises in the Unorganised Sector (set up in 2004, chaired by Arjun Sengupta) defined the unorganised sector as unincorporated private enterprises owned by individuals or households, run on a proprietary or partnership basis, with fewer than ten workers. "Organised" describes the enterprise, "formal" the job: a contract worker without social security in a large factory is an informal worker in the organised sector. Most Indian workers are informal: in the PLFS for 2025, **56.2%** of workers were self-employed, **20.2%** were casual labourers and only **23.6%** had regular wage or salaried jobs, and 58.2% of such employees outside agriculture had no written job contract (Chapters 49 and 52).

05 India's Sectoral Shape Today

As countries develop, the weight of their economy usually moves from the primary to the secondary and then to the tertiary sector. This shift is called **structural transformation**. In W. Arthur Lewis's dual-sector

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model (1954), workers who add little on overcrowded farms move to factories and towns, where they produce more and earn more. On this basis economies are often described by their dominant sector:

- **Agrarian economy:** the primary sector produces half or more of output and employs most people.
- **Industrial economy:** industry is the largest contributor to output.
- **Service economy:** services produce more than half of output and employ most workers.
- **Post-industrial society:** one where services have overtaken industry in output and jobs, as in most rich countries.

India's path has been unusual. At Independence agriculture produced roughly half of national output and employed about seven in ten workers. Instead of moving first into factories, India's output shifted directly towards services, while workers left farms only slowly. In 2025-26 manufacturing was only about 14.9% of **gross value added** (GVA), the value producers add to the inputs they buy (Chapter 2). By output India is a service economy; by employment it is still led by agriculture. On the shares in Figure 1.4, a farm worker produces only about a quarter as much as a service worker, so farm incomes lag. One reason is **disguised unemployment**, where more people work on a farm than are needed (Chapters 42 and 52); the gap lies behind much rural distress.

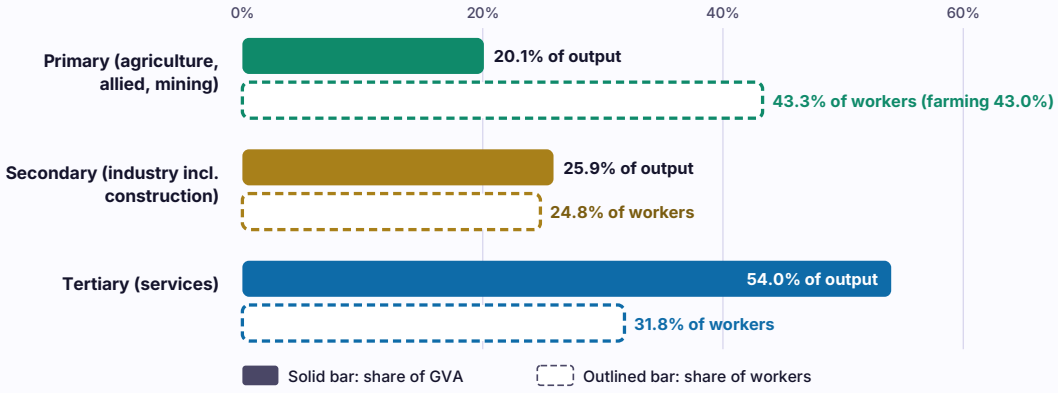
DATA BOX INDIA'S ECONOMY AT A GLANCE

INDICATOR	VALUE
GDP at current prices (nominal), 2025-26	₹345.37 lakh crore
Real GDP growth (price rises removed), 2025-26	7.8%
Real GDP growth, April–June 2026 (Q1 of 2026-27)	7.8%
Share in GVA, 2025-26: primary / secondary / tertiary	20.1% / 25.9% / 54.0%
Share of workers in agriculture, 2025	43.0% (down from 44.8% in 2024)
Share of workers in manufacturing / construction, 2025	12.1% / 12.0%

Source: NSO, Press Note on Q1 2026-27 GDP and National Accounts Statistics 2026, 31 August 2026 (sector shares computed from Statement 8.17.2, current prices, base 2022-23); PLFS Annual Report 2025, 27 March 2026.

Where India's Output Comes From, and Where Its Workers Are

Share of each broad sector in output (GVA, current prices, 2025-26) and in employment (2025). Services make the most; farms employ the most.



Sources: NSO, National Accounts Statistics 2026 (31 Aug 2026), Statement 8.17.2 (base 2022-23); PLFS Annual Report 2025, Statement 8 (usual status, ps+ss). Worker shares are sums of PLFS industry divisions: primary = agriculture 43.0 + mining 0.3; secondary = manufacturing 12.1 + utilities 0.7 + construction 12.0.

Fig. 1.4 Services produce over half of India's output, while agriculture alone still employs 43% of its workers.

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IN THE NEWS 2026: WHERE DOES INDIA RANK?

Rankings by GDP depend on the measure used. In the International Monetary Fund's (IMF) *World Economic Outlook* of October 2026, India's nominal GDP for 2026 is about **$4.06 trillion**, the **sixth** largest after the United States, China, Germany, Japan and the United Kingdom; the IMF projects India to become the fourth largest in 2027. A weaker rupee lowers the dollar figure. At **purchasing power parity**, which adjusts for lower prices in India, India has long been the **third** largest economy (Chapter 2).

06 Goods and Services: Key Types

Goods are tangible things that can be seen, stored and transported: rice, a bicycle, a laptop. **Services** are intangible activities that satisfy wants: a haircut, a train journey, a doctor's advice, a UPI payment. Services cannot be stored (an empty seat on today's flight is lost for ever) and are produced and used together.

By Use: Final, Intermediate, Consumer and Capital Goods

- **Final goods** are bought for final use (consumption or investment); they are not resold or used up in production within the year.
- **Intermediate goods** are used up as inputs in producing other goods within the year: cotton for a mill, flour for a bakery, steel sheets for a carmaker.
- **Consumer goods** satisfy wants directly. They are **durable** (a fridge, a scooter), **semi-durable** (clothes, shoes) or **non-durable** (milk, vegetables).
- **Capital goods** are final goods that produce other goods over many years: a tractor, a power loom, a factory. Their wear and tear is **depreciation**.

COMMON CONFUSION: FINAL VS INTERMEDIATE GOODS

Its **use**, not the good itself, decides. Milk bought by a family is final; the same milk bought by a sweet shop for rasgulla is intermediate. Only final goods enter GDP; counting flour **and** bread would count the flour twice (**double counting**). A tractor is a final (capital) good: it lasts for years.

By How Buyers Respond to Income and Prices

Microeconomics also classifies goods by how demand reacts when a buyer's income or a related price changes:

TYPE	BEHAVIOUR	EXAMPLE
Normal good	Demand rises as income rises	Milk, clothes, air travel
Inferior good	Demand falls as income rises, as buyers switch to better items	Coarse grain, kerosene, cheap bus travel

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TYPE	BEHAVIOUR	EXAMPLE
Giffen good	A special inferior good: more of it is bought when its own price rises, because very poor buyers can no longer afford the costlier alternative	A staple food for the very poor (named after Robert Giffen)
Veblen good	More is bought at a higher price, because a high price signals status	Luxury watches, designer handbags (after Thorstein Veblen)
Substitutes	Can replace each other: if the price of one rises, demand for the other rises	Tea and coffee; bus and metro rides
Complements	Used together: if the price of one rises, demand for the other falls	Car and petrol; printer and ink

◆ PRELIMS FACT INFERIOR, GIFFEN AND VEBLEN

- Every Giffen good is an inferior good, but most inferior goods are **not** Giffen goods.
- Giffen and Veblen goods both break the law of demand, for opposite reasons: poverty in one case, show in the other.

07 Public, Private and Merit Goods

START HERE WHO PAYS FOR THE STREET LIGHT?

A street light in your lane lights the way for everyone who walks past, whether they paid or not, and one more walker does not make it dimmer. No shopkeeper could sell "street light tickets", because nobody can be kept out of the light. If street lights were left to the market, few would be built. That is why the municipality puts them up and pays for them out of taxes.

Two tests sort goods into four groups:

- **Rivalry:** does one person's use reduce what is left for others? A samosa eaten by you cannot be eaten by me.
- **Excludability:** can those who do not pay be kept out? A cinema can sell tickets; national defence protects everyone in the country.

Public goods are non-rival and non-excludable: one person's use does not reduce another's, and no one can be kept from using them. Paul Samuelson set out the theory in 1954. Because people can enjoy them without paying, each person is tempted to let others pay: the **free-rider problem**. Private firms therefore supply too little of them, and governments provide them through taxes. Providing public goods such as defence, police, justice and roads is the **allocation** function of a government budget, alongside redistribution and stabilisation (Chapter 26).

Common-pool resources such as groundwater, fish stocks and village grazing land are open to all but can be used up. Each user gains from taking more while the cost of depletion is shared by everyone, so they are over-used: the **tragedy of the commons** described by Garrett Hardin in 1968. Falling water tables in Punjab and Haryana are an Indian example.

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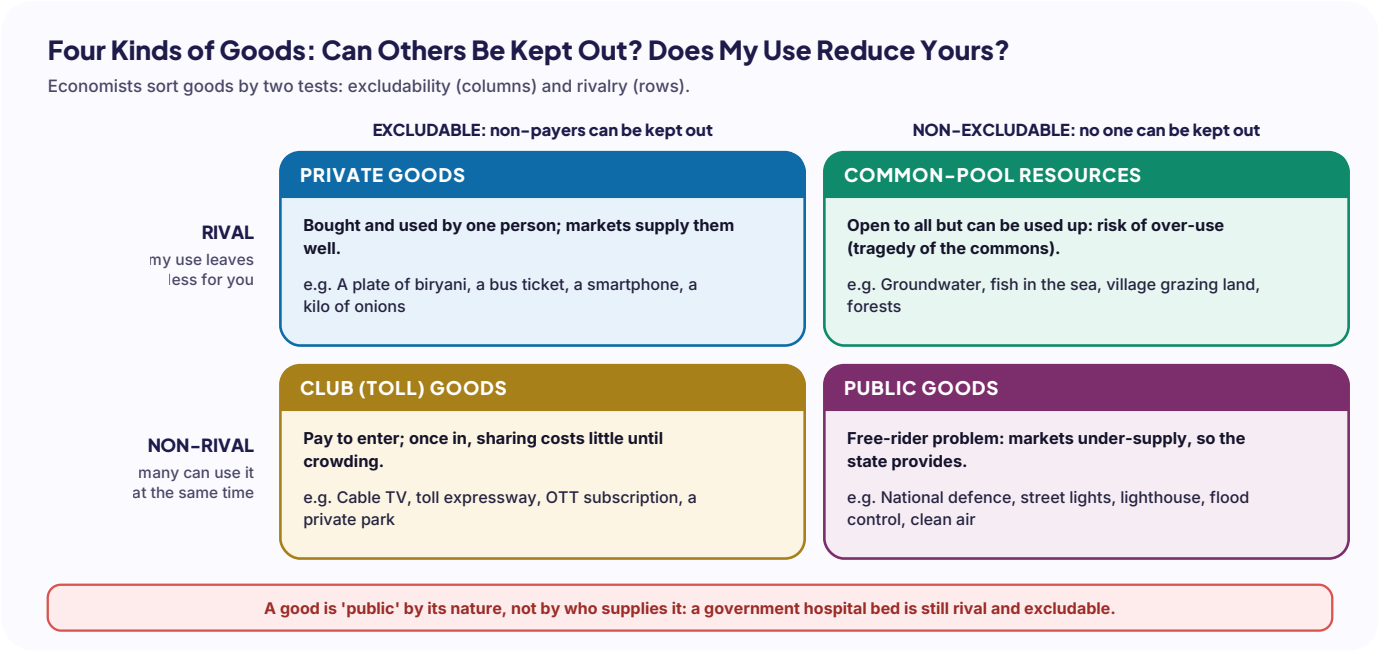


Fig. 1.5 Rivalry and excludability give four kinds of goods; pure public goods are neither rival nor excludable.

CONCEPT: DIGITAL PUBLIC INFRASTRUCTURE

Aadhaar, UPI, DigiLocker and similar open platforms are called **digital public infrastructure** (DPI). Like a road, one more user costs almost nothing, and any bank or app can build on them. India has offered this "India Stack" model to other countries. DPI shows how the state can create a public good on which private firms then compete (Chapters 18 and 48).

Merit Goods, Demerit Goods and Externalities

Merit goods are goods that society thinks people should consume more of than they would choose on their own, because the benefits are larger than individuals realise: education, health care, vaccination, nutrition. The idea is associated with Richard Musgrave. Governments provide or subsidise them, for example through free school meals, Ayushman Bharat and immunisation drives. **Demerit goods**, such as tobacco and alcohol, harm the user and others more than buyers recognise, so governments tax, restrict or discourage them. Since 22 September 2025 the goods and services tax (GST) has charged a special 40% rate on sin and luxury goods such as aerated sugary drinks and large cars; pan masala and most tobacco products joined that slab on 1 February 2026 (Chapter 29).

An **externality** is a cost or benefit that falls on people outside a transaction. Smoke from a factory or from stubble burning in Punjab is a **negative externality**; a vaccinated child who protects classmates, or bees from an apiary pollinating a neighbour's orchard, creates a **positive externality**. Markets produce too much of goods with negative externalities and too little of those with positive ones. Such cases, along with public goods and monopoly, are called **market failure**, and they are the main economic reasons for government action.

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COMMON CONFUSION: PUBLIC GOOD VS PUBLICLY PROVIDED GOOD

A **public good** is defined by its nature (non-rival, non-excludable), not by who supplies it. A bed in a government hospital or a ration-shop kilo of rice is supplied by the state, yet it is rival and excludable, so it is a **publicly provided private good** or a merit good. Conversely, a private firm can maintain a public good such as a lighthouse under contract.

08 Markets, Demand and Supply

START HERE WHY ONIONS COST ₹20 ONE MONTH AND ₹80 THE NEXT

At the Lasalgaon mandi, the price of onions changes almost daily. Nobody fixes it. When rain damages the crop, fewer onions reach the market, buyers compete for them and the price shoots up. When a bumper harvest arrives, traders have more than buyers want and the price crashes. The price is set by the tug of war between buyers (demand) and sellers (supply), and it in turn tells farmers what to grow next season.

In economics, a **market** is any arrangement through which buyers and sellers exchange a good or service at a price. It need not be a physical place: a village haat, a stock exchange and an e-commerce app are all markets.

Demand

Demand is the quantity of a good that buyers are willing and able to buy at each price during a period. The **law of demand** states that, other things remaining the same, the quantity demanded of a good falls when its price rises, and rises when its price falls. Giffen and Veblen goods are the classic exceptions. Besides the good's own price, demand depends on buyers' income, the prices of substitutes and complements, tastes, expectations of future prices and the number of buyers.

Supply

Supply is the quantity that sellers are willing and able to offer at each price during a period. By the **law of supply**, sellers offer more at a higher price, other things being equal. Supply also depends on input costs, technology, weather, taxes and subsidies, and the number of sellers.

Equilibrium: Where the Price Settles

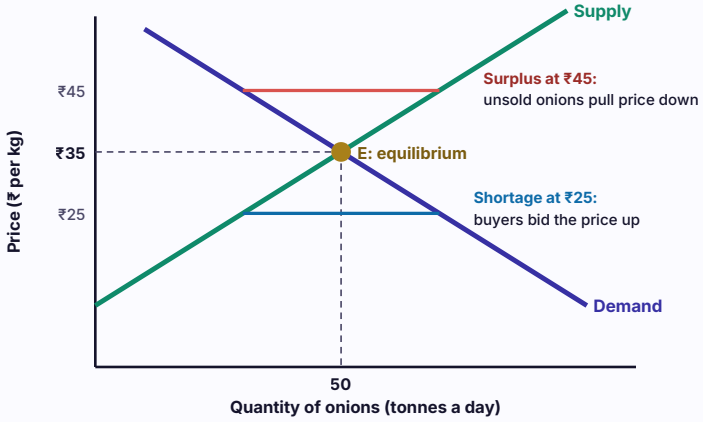
The **equilibrium price** is the price at which the quantity buyers want equals the quantity sellers offer. Above it, unsold stocks (a **surplus**) push the price down; below it, unmet demand (a **shortage**) pushes it up. Prices thus act as signals that coordinate millions of decisions without a central planner, the "invisible hand" that Adam Smith described in *The Wealth of Nations* (1776).

Governments sometimes override the market price. A **price ceiling** is a legal maximum, such as the ceiling prices that the National Pharmaceutical Pricing Authority fixes for essential medicines. A **price floor** is a legal minimum, such as minimum wages; the minimum support price (MSP), at which the government buys certain crops, works as a floor only where the government actually buys (Chapter 44). A ceiling below equilibrium tends to cause shortages; a floor above it, surpluses.

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How a Market Sets the Price: Onions at a Mandi

Buyers want more when the price is low; sellers offer more when it is high. The price settles where the two meet.



WHAT SHIFTS THE WHOLE CURVE

- Demand: income, prices of substitutes and complements, tastes, festivals, expectations, population
- Supply: input costs, weather and harvest, technology, taxes and subsidies, number of sellers

MOVE ALONG A CURVE OR SHIFT OF A CURVE?

- Move along: caused only by a change in the good's own price
- Shift of the whole curve: caused by anything else (income, weather, a new tax)

Numbers are illustrative.

Fig. 1.6 The market clears at E; a price above it leaves a surplus and a price below it leaves a shortage.

COMMON CONFUSION: CHANGE IN QUANTITY DEMANDED VS CHANGE IN DEMAND

A **change in quantity demanded** is a movement *along* the same demand curve, caused only by a change in the good's own price. A **change in demand** is a *shift* of the whole curve, caused by anything else: higher incomes, a festival, a rise in the price of a substitute. If onion prices rise because of crop damage, buyers' quantity demanded falls; if Diwali bonuses raise spending on sweets, demand for sugar rises.

Elasticity in One Page

Price elasticity of demand measures how strongly the quantity demanded responds to a change in price:

Price elasticity = percentage change in quantity demanded ÷ percentage change in price (ignoring the minus sign).

Demand is more elastic when close substitutes exist, when the good is a luxury rather than a necessity, when it takes a large share of the budget, and over a longer time. Onions have few substitutes, so their demand is inelastic: after even a small shortfall, the price must rise a lot before buyers cut back enough. Governments likewise tax goods with inelastic demand, such as fuel and tobacco: sales fall little, so collections hold up.

VALUE	NAME	MEANING AND EXAMPLE
Greater than 1	Elastic	Buyers react strongly: branded snacks, restaurant meals, foreign holidays
Less than 1	Inelastic	Buyers react weakly: salt, rice, onions, life-saving drugs, petrol in the short run
Equal to 1	Unit elastic	Spending on the good stays the same as price changes
Zero / infinite	Perfectly inelastic / elastic	Textbook extremes, rarely seen in practice

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WORKED EXAMPLE **IS THE DEMAND FOR ONIONS ELASTIC?**

The price of onions rises from ₹40 to ₹48 a kg, and a family cuts its purchase from 10 kg to 9.5 kg a month.

STEP	VALUE
Change in price: (48 − 40) ÷ 40 × 100	+20%
Change in quantity: (9.5 − 10) ÷ 10 × 100	-5%
Elasticity: 5 ÷ 20	0.25
Verdict	Inelastic (less than 1)

Spending rises from ₹400 to ₹456: with inelastic demand, a price rise increases total spending.

◆ PRELIMS TRAP **ELASTICITY IS NOT SLOPE**

- Along a straight-line demand curve the slope is constant, but elasticity is **not**: demand is elastic at high prices and inelastic at low prices.
- With inelastic demand, a **bumper harvest** can lower farmers' total income, because prices fall by a larger percentage than sales rise: the reason tomato and onion growers suffer in glut years.

Income elasticity of demand compares the change in quantity demanded with the change in income. It is positive for normal goods, negative for inferior goods, below 1 for necessities and above 1 for luxuries. The German statistician Ernst Engel observed that as households grow richer, the **share** of income spent on food falls (**Engel's law**). India fits the pattern: food took about 53% of the average monthly spending of rural households and 43% of urban households in 2011-12, but only 47.04% and 39.68% in 2023-24 (NSO, *Household Consumption Expenditure Survey 2023-24*).

Markets also differ by the number of sellers: many under **perfect competition** (wheat traders in a mandi), one under **monopoly**, a few under **oligopoly** (telecom, airlines), and many with slightly different products under **monopolistic competition** (restaurants). The Competition Commission of India checks abuse of market power (Chapter 47).

09 The Circular Flow of Income

START HERE **WHERE DOES YOUR ₹100 GO?**

You pay ₹100 at a dhaba for a thali. The owner uses it to pay the cook's wages, the rent for the shop, interest on his loan for the tandoor, and keeps the rest as profit. The cook spends his wages on vegetables and school fees; the vegetable seller spends hers on cloth and mobile recharges. The same money keeps moving from buyers to producers and back to people as income. This endless loop is the circular flow of income.

The **circular flow of income** shows how money, goods and services move between the main groups in an economy: households, firms, the government and the rest of the world (each is called a "sector" in this model). It rests on one simple fact: one person's spending is another person's income.

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Two-Sector Model: Households and Firms

Imagine an economy with only households and firms, no government, no foreign trade and no saving. **Households** own the factors of production and sell their services to **firms**. Firms use them to produce goods and services, which they sell to households. Two flows run in opposite directions:

- A **real flow** of factor services (households to firms) and of goods and services (firms to households).
- A **money flow** of factor incomes such as wages, rent, interest and profit (firms to households) and of consumption spending (households to firms).

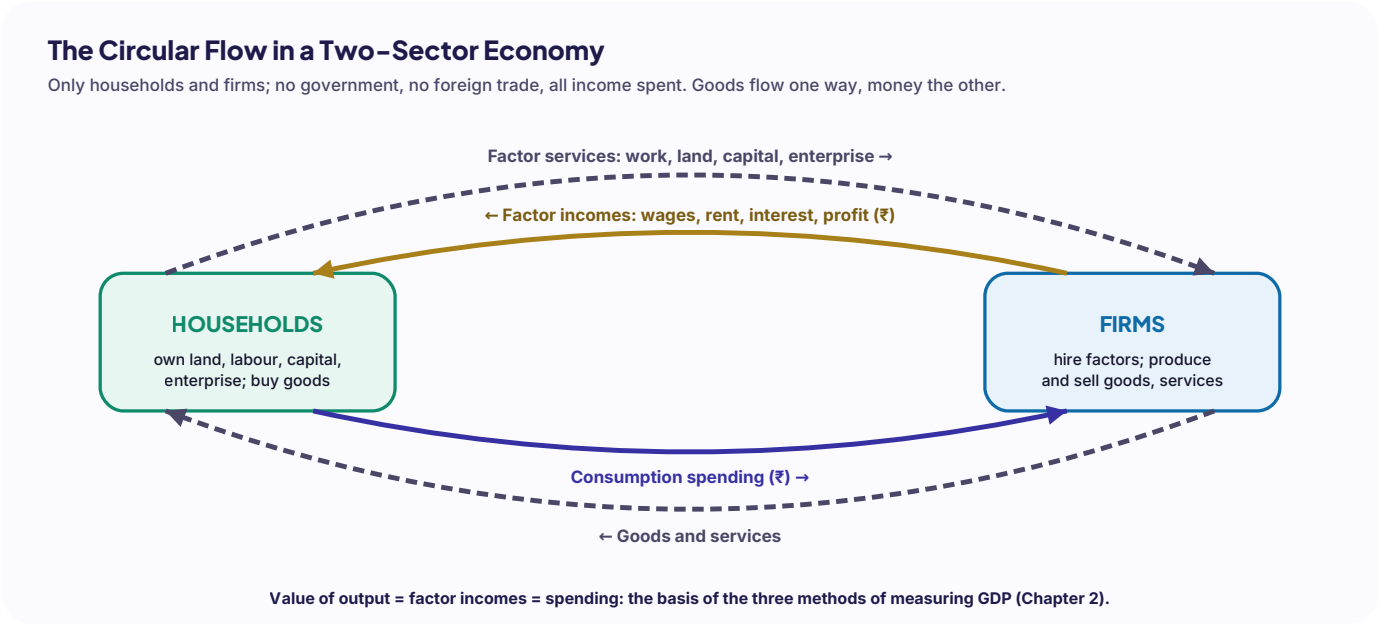


Fig. 1.7 In the simplest economy, what firms pay out as incomes returns to them as spending.

In this loop the value of output, the total of factor incomes and the total of spending are equal. That equality is why GDP can be measured in three ways, by production, by income and by expenditure (Chapter 2). Money, which keeps the loop moving, is the subject of Chapter 8.

Leakages and Injections

Real economies are not closed loops. Some income drains out of the flow of spending, and some spending enters it from outside:

- **Leakages (withdrawals): saving** (S), **taxes** (T) and spending on **imports** (M). Each takes money away from purchases of domestic output.
- **Injections: investment** by firms (I), **government spending** (G) and **exports** (X). Each adds spending that does not come from households' current consumption.

In the **three-sector model** the government joins: it collects taxes and spends on goods, services and salaries, and makes **transfer payments** such as pensions, scholarships and subsidies. In the **four-sector model** the **rest of the world** joins through exports and imports and flows of capital. An economy with neither exports nor imports is a **closed economy**; one that trades goods, services and capital with other countries is an **open economy**, as India is. Financial markets (banks, bond and share markets) carry household saving to the firms that invest it.

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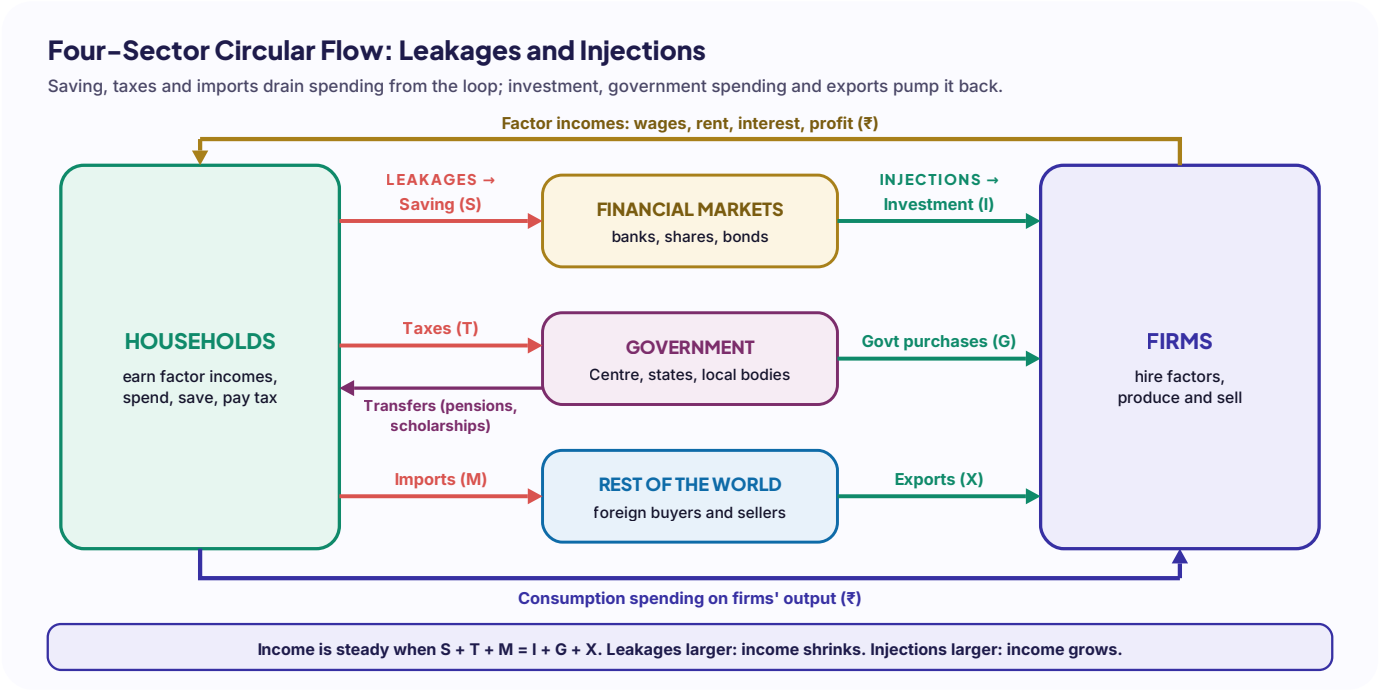


Fig. 1.8 Leakages leave the household–firm loop; injections re-enter it. National income settles where the two balance.

National income is stable when total leakages equal total injections: S + T + M = I + G + X. If injections exceed leakages, spending and income rise; if leakages exceed injections, income falls until the two balance again. In terms of spending, output in an open economy with a government equals **C + I + G + (X − M)**, where C is households' consumption spending: the Keynesian expression for **aggregate demand**, the total spending on a country's output.

CONCEPT: THE PARADOX OF THRIFT

Keynes noted that if **everyone** tries to save more at once, spending falls, firms cut jobs and incomes, and total saving may not rise at all: the **paradox of thrift**. It bites mainly in a slump; in normal times saving that banks lend for investment raises future output.

WORKED EXAMPLE — WILL NATIONAL INCOME GROW OR SHRINK?

ITEM (₹ CRORE)	YEAR 1	YEAR 2
Leakages: S + T + M	15 + 10 + 20 = 45	15 + 10 + 20 = 45
Injections: I + G + X	20 + 15 + 10 = 45	20 + 15 + 5 = 40
Result	Steady	Falls

In Year 2 leakages exceed injections by ₹5 crore, so income falls. A fall in exports (a global slowdown, a tariff in a large export market) reduces injections. Higher government spending or private investment can make up the gap.

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COMMON CONFUSION: FACTOR PAYMENTS VS TRANSFER PAYMENTS

Factor payments (wages, rent, interest, profit) are earned in return for helping to produce something; they are **primary income** and form part of national income. **Transfer payments** (old-age pensions, scholarships, unemployment allowances, gifts, PM-KISAN instalments) are received without any productive service in return; they are **secondary income** and only redistribute existing income, so they are **not** counted again in national income.

10 Stocks and Flows

START HERE YOUR BANK BALANCE AND YOUR SALARY

"My salary is ₹40,000" means nothing until you add "a month": a salary is measured over a period of time. "My bank balance is ₹1 lakh" needs only a date: it is measured at a point of time. The salary is a flow; the balance is a stock. Every time salary comes in and spending goes out, the stock changes.

A **stock** is a quantity measured at a particular point of time; a **flow** is a quantity measured over a period of time. In a water tank, the water inside at 9 am is a stock; the litres per minute running in or out are flows.

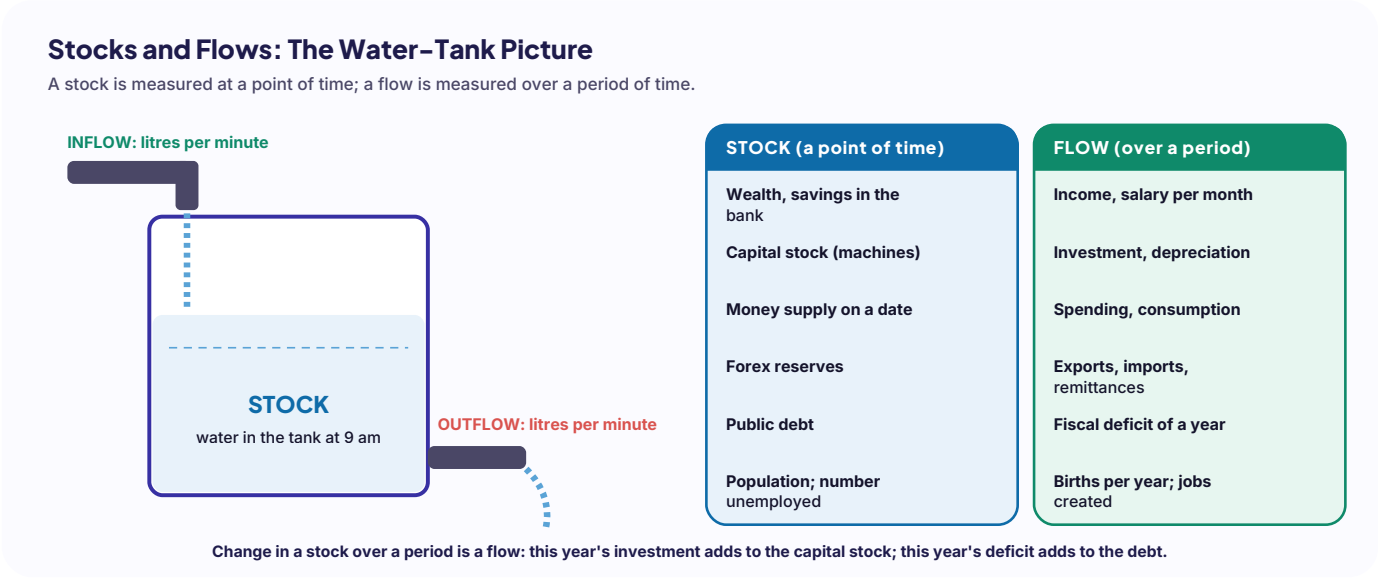


Fig. 1.9 A stock is a level on a date; a flow is a rate per period.

Flows change stocks. Each year's **investment** (a flow) adds to the **capital stock**, while **depreciation** (also a flow) wears it down: **net investment = gross investment – depreciation**. In the same way, what a government borrows in a year, its **fiscal deficit** (a flow), adds to its accumulated **debt** (a stock; Chapter 27), and this year's addition to foreign exchange (forex) reserves (a flow) changes the level of reserves (a stock).

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◆ PRELIMS TRAP STOCK OR FLOW?

- **Stocks:** wealth, capital, money supply on a date, forex reserves, public debt, inventories, population, number of unemployed persons.
- **Flows:** income, GDP, investment, depreciation, consumption, exports and imports, fiscal deficit, interest payments, rent per month, births per year.
- Money supply is a stock, but the **velocity** with which money changes hands is measured per period (Chapter 8).

Market and Non-Market Activities

Not every useful activity enters national income. **Market activities** produce goods and services for sale and are counted. Some **non-market** production is also counted by valuing it at market prices: grain a farm family grows and eats itself, and the rent that owners of houses would have paid had they been tenants (**imputed rent**). But unpaid **domestic and care services** within the household (cooking, cleaning, caring for children and the elderly) are **not** counted. The *Time Use Survey 2024* found that women and girls who did unpaid domestic work for their households spent on average 289 minutes a day on it, against 88 minutes for men and boys (NSO, 25 February 2025). This is one of the main criticisms of GDP as a measure of welfare (Chapter 2).

11 Economic Systems in Brief

The central problems of what, how and for whom to produce can be solved by the market, by the state, or by a mix of both. These answers give three broad **economic systems**:

FEATURE	CAPITALIST (MARKET)	SOCIALIST (CENTRALLY PLANNED)	MIXED
Ownership of means of production	Mainly private	Mainly state or collective	Both public and private
Who decides what to produce	Prices and profit (aim: efficiency)	Planners (aim: equality)	Market, guided by state policy
Intellectual roots	Adam Smith (1776), *laissez-faire*	Karl Marx; Soviet plans from 1928	Keynes; post-war welfare states
Examples	United States (closest)	Former Soviet Union; China before 1978	India, most countries today

In practice almost every economy is mixed; they differ in how much the state does. India chose a **mixed economy** after Independence, with a large public sector in heavy industry and infrastructure and planning through Five-Year Plans (Chapter 6). Article 39(b) and (c) ask the State to use material resources for the common good and prevent concentration of wealth; the 42nd Amendment (1976) added "socialist" to the Preamble. From 1991 India turned more market-led (Chapter 7); in November 2024 the Supreme Court upheld "socialist" in the Preamble as meaning a welfare state that does not bar private enterprise.

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CONNECTING THE DOTS FROM SCARCITY TO THE WHOLE ECONOMY

- Scarce land, labour, capital and enterprise force choices about what, how and for whom to produce
- Production in three sectors pays factor incomes that circulate as spending
- That flow, measured three ways, is GDP (Chapter 2); its rise is growth, its swings are business cycles (Chapter 3)
- Prices are tracked as inflation (Chapters 4, 5); the state steers through plans, money and budgets

USING THIS CHAPTER IN MAINS

Questions on growth, jobs and inclusion start here. To explain why growth has not created enough good jobs, contrast sector shares of output and employment and use structural transformation: India moved from farms to services, largely skipping the factory stage. On the role of the state, ground the case in public goods, merit goods, externalities and market failure, and weigh it against government failure (waste, delay, poor targeting). Use leakages and injections to show why weaker exports or private investment slow the whole economy.

Chapter 1 at a Glance

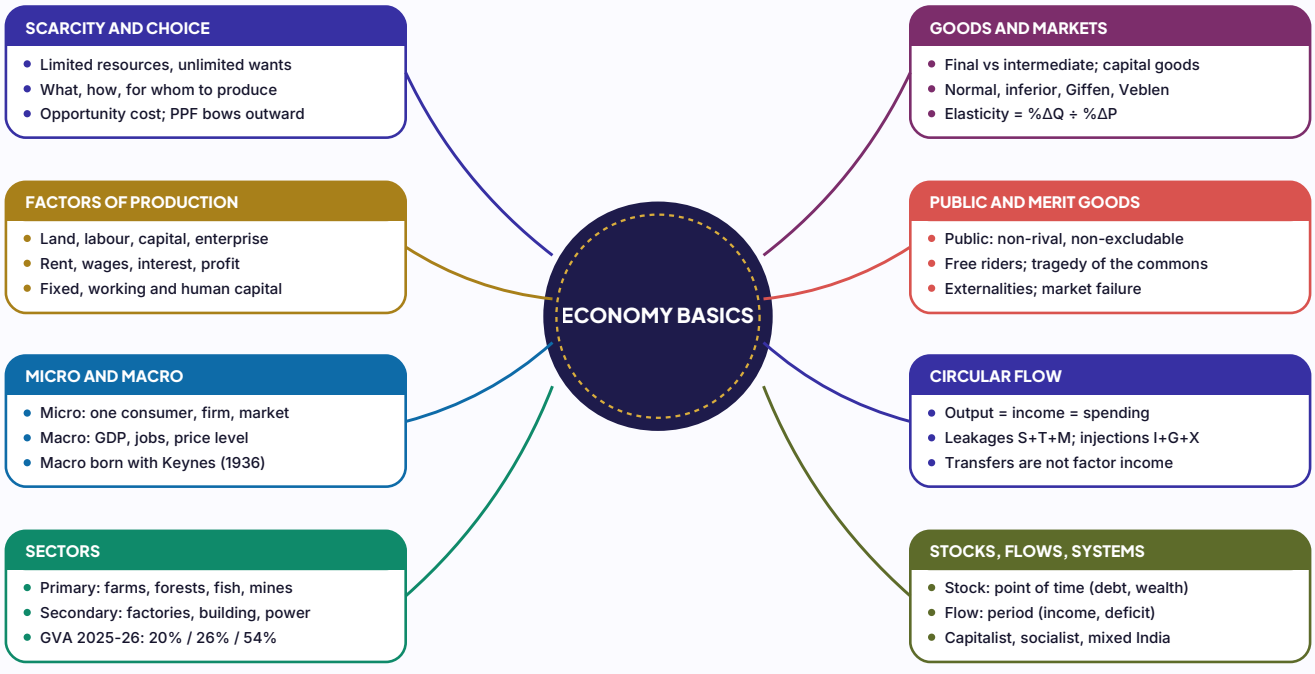


Fig. 1.10 Chapter 1 at a glance: the whole chapter on one page for quick revision.

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Prelims Quick Revision

- **Opportunity cost**: value of the next best alternative given up.
- **Free provision**: its opportunity cost shifts to taxpayers.
- **PPF**: bows outward; growth shifts it out; inside means idle resources.
- **Sectors**: mining is primary; construction, utilities secondary; storage tertiary.
- **Real sector**: farming, textile mills; lending and bonds are financial.
- **GVA 2025-26**: primary 20.1%, secondary 25.9%, tertiary 54.0%.
- **PLFS 2025**: 43.0% of workers in agriculture; 23.6% salaried.
- **Capital**: plough, computer fixed; yarn, petrol working capital.
- **Public goods**: non-rival, non-excludable; free riders.
- **Merit goods**: education, health (subsidised); demerit goods: tobacco, alcohol (taxed).
- **Elasticity**: % change in quantity ÷ % change in price; below 1 is inelastic (onions, salt).
- **Circular flow**: steady when S + T + M = I + G + X.
- **Closed economy**: neither exports nor imports take place.
- **Transfer payments**: pensions, scholarships; not counted in national income.
- **Stocks vs flows**: debt, wealth are stocks; deficit, income flows.

Previous Year Questions

2024

With reference to the sectors of the Indian economy, consider the following pairs :

Economic activity — Sector

1. Storage of agricultural produce — Secondary
2. Dairy farm — Primary
3. Mineral exploration — Tertiary
4. Weaving cloth — Secondary

How many of the pairs given above are correctly matched ?

a Only one | **b Only two** | c Only three | d All four

Answer: (b). Dairy farming is primary and weaving secondary. Storage is a service (tertiary) and exploration goes with mining (primary), so only 2 and 4 match (Section 04).

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2024 With reference to physical capital in Indian economy, consider the following pairs :

Items — Category

1. Farmer's plough — Working capital
2. Computer — Fixed capital
3. Yarn used by the weaver — Fixed capital
4. Petrol — Working capital

How many of the above pairs are correctly matched ?

a Only one | b Only two | c Only three | d All four

Answer: (b). A plough and a computer last for years (fixed capital); yarn and petrol are used up in one round (working capital). Pairs 2 and 4 match (Section 02).

2023 Consider the investments in the following assets :

1. Brand recognition
2. Inventory
3. Intellectual property
4. Mailing list of clients

How many of the above are considered intangible investments?

a Only one | b Only two | c Only three | d All four

Answer: (c). Brand recognition, intellectual property and client lists are intangible; inventory is a tangible stock of goods (Section 02).

2022 Which of the following activities constitute real sector in the economy ?

1. Farmers harvesting their crops
2. Textile mills converting raw cotton into fabrics
3. A commercial bank lending money to a trading company
4. A corporate body issuing Rupee Denominated Bonds overseas

Select the correct answer using the code given below :

a 1 and 2 only | b 2, 3 and 4 only | c 1, 3 and 4 only | d 1, 2, 3 and 4

Answer: (a). Farming and milling produce goods (real sector); bank lending and bond issues are financial-sector activities (Section 04).

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2021 Consider the following statements :

Other things remaining unchanged, market demand for a good might increase if

1. price of its substitute increases
2. price of its complement increases
3. the good is an inferior good and income of the consumers increases
4. its price falls

Which of the above statements are correct?

a 1 and 4 only | b 2, 3 and 4 | c 1, 3 and 4 | d 1, 2 and 3

Answer: (a). 1 shifts demand up. 4 raises the quantity bought, strictly a move along the curve, which the key counts. 2 and 3 lower demand (Sections 06, 08).

2018 If a commodity is provided free to the public by the Government, then

a the opportunity cost is zero.

b the opportunity cost is ignored.

c the opportunity cost is transferred from the consumers of the product to the tax-paying public.

d the opportunity cost is transferred from the consumers of the product to the Government.

Answer: (c). The cost moves from users to taxpayers; it does not vanish (Section 01).

2015 The substitution of steel for wooden ploughs in agricultural production is an example of

a labour-augmenting technological progress

b capital-augmenting technological progress

c capital-reducing technological progress

d None of the above

Answer: (b). A steel plough is a better tool: the capital itself becomes more productive, so the progress is capital-augmenting (Section 02).

2011 A "closed economy" is an economy in which

a the money supply is fully controlled | b deficit financing takes place

c only exports take place | d neither exports nor imports take place

Answer: (d). No foreign trade at all, neither exports nor imports, makes an economy closed (Section 09).

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UNIT II | 11 CHAPTERS

Money, Banking and Monetary Policy

Money and the money multiplier, crypto and CBDC, the RBI and its autonomy, the monetary policy framework and its tools, transmission, the banking structure, NBFCs, bad loans and the IBC, regulation and deposit insurance, and payment systems.

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09 Cryptocurrency, CBDC and the Future of Money
Blockchain: The Technology Underneath · Cryptocurrency and Bitcoin · Stablecoins, NFTs and Tokens · India's Crypto Policy: Tax, Not Ban

10 The Reserve Bank of India: Structure, Functions and Autonomy
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11 The Monetary Policy Framework: MPC and Inflation Targeting
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INDIAN ECONOMY · PRELIMS · GS PAPER III

Tools of Monetary Policy: CRR, SLR, Repo, SDF, MSF and OMOs

On 7 October 2026 the RBI raised the repo rate to 5.50%, yet the banking system that week held a surplus of about **₹5 lakh crore** of idle money, much of it created by the RBI's own dollar swaps earlier in the year. Asked whether he would raise the cash reserve ratio to soak it up, Governor Sanjay Malhotra called a CRR increase one of the RBI's "least preferred" ways of taking out liquidity. Instead the RBI leaned on reverse repo auctions and sales of government bonds.

Why does a central bank need so many levers, and why prefer one over another? This chapter opens the RBI's toolbox one instrument at a time.

The RBI's structure and functions are in Chapter 10; the Monetary Policy Committee, the inflation target and the policy stance in Chapter 11; and how rate changes reach your loan EMI in Chapter 13. Money markets (call money, T-bills, TREPS) are in Chapter 19 and bond yields in Chapter 20.

SYLLABUS

PRELIMS Economic and Social Development – Sustainable Development, Poverty, Inclusion, Demographics, Social Sector Initiatives, etc

MAINS · GS PAPER III Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment

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01 The RBI's Toolkit at a Glance

START HERE FOUR QUESTIONS BEHIND EVERY LOAN

A kirana owner in Indore asks her bank for a ₹5 lakh working-capital loan. Whether she gets it, and at what rate, depends on four things the RBI controls. How much of its deposits must the bank lock away? What does the bank pay to borrow overnight from the RBI? Is the RBI pumping cash into the system or pulling it out? And does the RBI want more lending to small shops and less to, say, speculators in land? Each question is answered by a different monetary policy tool.

Monetary policy uses **instruments** (tools) to influence the cost and availability of money and credit, and through them inflation and growth (objectives in Chapter 11). The tools fall into two families.

- **Quantitative tools**, also called general tools, change the overall volume and price of credit in the whole economy: the cash reserve ratio (CRR), statutory liquidity ratio (SLR), policy repo rate and the corridor around it (the standing deposit facility, SDF, and marginal standing facility, MSF), open market operations (OMOs) and foreign exchange swaps.
- **Qualitative tools**, also called selective tools, change the direction of credit towards or away from particular sectors or borrowers: margin requirements and loan-to-value limits, selective credit controls, risk weights, moral suasion and direct action.

BASIS	QUANTITATIVE (GENERAL)	QUALITATIVE (SELECTIVE)
Controls	**Volume and cost** of total credit	**Direction** of credit to sectors
Reach	Whole economy, every borrower	Chosen sectors, products or borrowers
Examples	CRR, SLR, repo rate, SDF, MSF, Bank Rate, OMOs, forex swaps	LTV and margins, selective credit control, risk weights, moral suasion, direct action
Typical use	Fight inflation or slowdown	Curb a bubble (gold, shares, unsecured loans) or support a sector

Older textbooks also label the two families "indirect" and "direct". The RBI uses these words differently: for it, reserve ratios and credit directions are **direct instruments** (they bind banks by rule), while repo and OMOs are **indirect instruments** (they work through the market).

Quantitative tools are further split into **price-based tools** (policy rates) and **quantity-based tools** (reserve ratios, OMOs, swaps). Since the 2000s the RBI has steered mainly through the price of overnight money, the repo rate, and uses the quantity tools to keep the market rate close to it.

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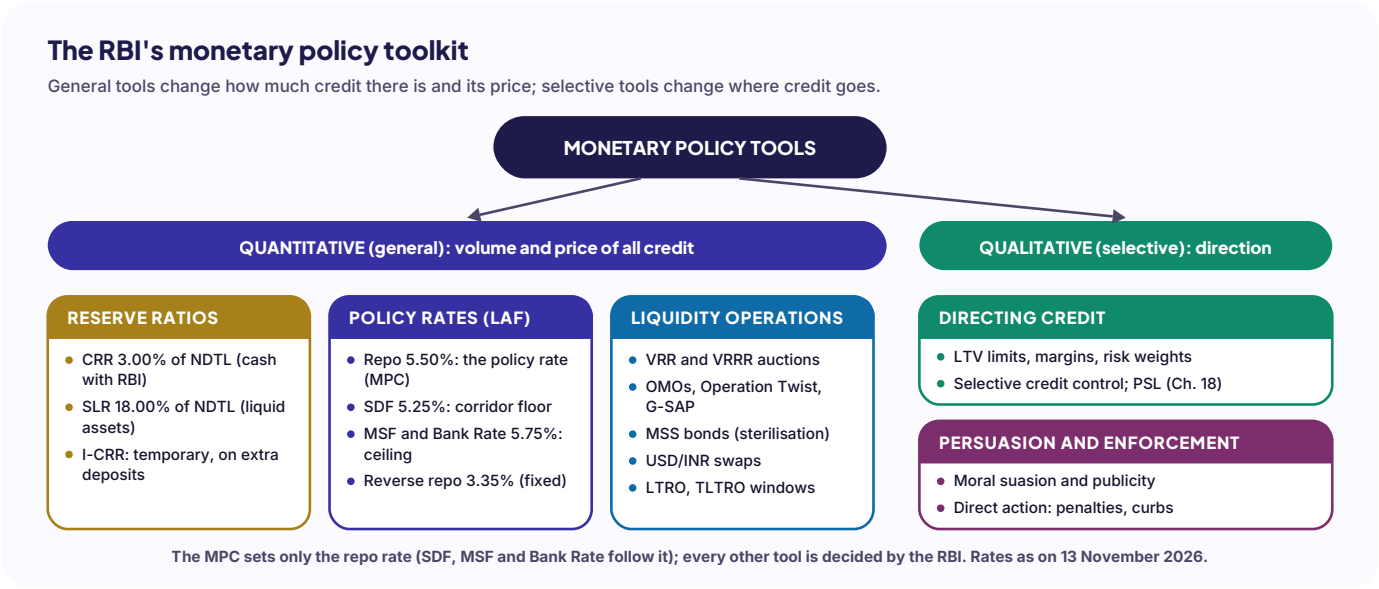


Fig. 12.1 The RBI's toolkit: general tools change the volume and price of all credit, selective tools change where credit goes.

PRELIMS TRAP WHO DECIDES WHICH TOOL

- The six-member **MPC decides only the policy repo rate** (and the stance). The RBI keeps the SDF, MSF and Bank Rate at fixed gaps from it, so they move with it.
- CRR, SLR, OMOs, swaps, LTV limits and every other tool are decided by the **RBI** itself, **not** by the MPC.
- **Public debt and public revenue** are tools of **fiscal** policy, set by the government through the Budget; Bank Rate and OMOs are monetary policy.

02 Cash Reserve Ratio (CRR)

START HERE WHY YOUR BANK CANNOT LEND ALL YOUR MONEY

Suppose you deposit ₹100 in your savings account. Your bank cannot lend out all ₹100. By law it must first send ₹3 to its current account with the RBI, where the money earns nothing, and it must hold another ₹18 in safe, easily sold assets such as government bonds. Only what is left can be lent to a car buyer or a small factory. The ₹3 rule is the **CRR**; the ₹18 rule is the **SLR**. Change either, and the money banks can lend changes at once.

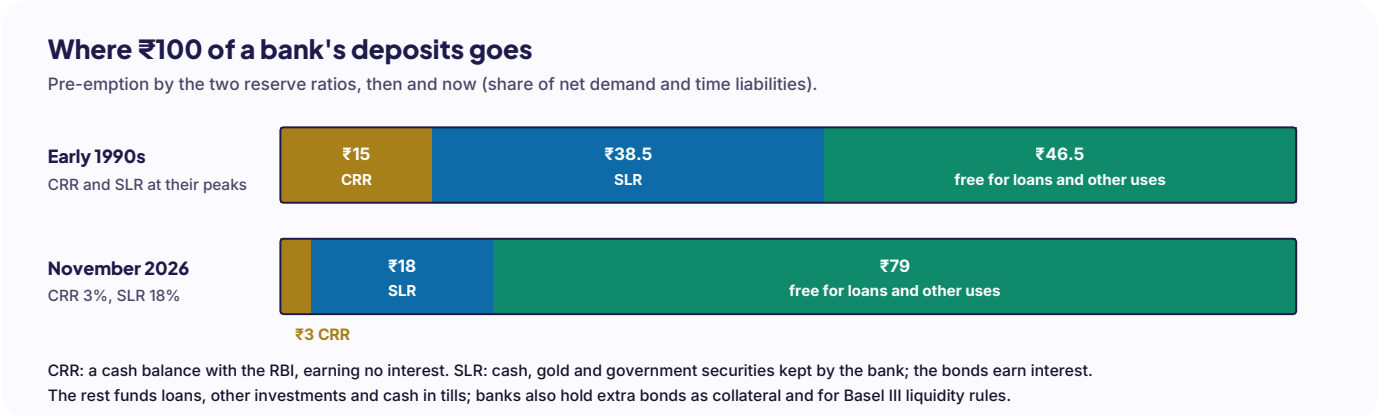


Fig. 12.2 Where ₹100 of deposits goes: ₹3 as CRR, ₹18 as SLR and ₹79 free, against ₹46.5 in the early 1990s.

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Net Demand and Time Liabilities (NDTL)

Both reserve ratios are percentages of a bank's **net demand and time liabilities (NDTL)**, which is essentially its deposits from the public.

- **Demand liabilities** are payable on demand: current account balances, the demand part of savings deposits, demand drafts and unclaimed or overdue deposits.
- **Time liabilities** are payable after a fixed period: fixed and recurring deposits and the time part of savings deposits.
- **"Net"** means liabilities to other banks are netted against assets with them, so inter-bank deposits are not counted twice.

What the CRR Is

The **cash reserve ratio** is the share of NDTL that a bank must keep as a cash balance with the RBI. It is **3.00% of NDTL** (since the fortnight beginning 29 November 2025).

- **Legal basis:** Section 42(1) of the RBI Act, 1934, for scheduled banks. Non-scheduled banks keep a cash reserve under Section 18 of the Banking Regulation Act, 1949.
- **No floor, no ceiling:** the RBI (Amendment) Act, 2006 removed the old legal limits (a floor of 3% and a ceiling of 20%), so the RBI may now fix any rate.
- **No interest:** the RBI pays **no** interest on CRR balances; the same amendment ended the earlier practice of paying some.
- **Maintenance:** banks must keep the required amount as an average over each reporting fortnight and at least **90%** of it on every single day. The Banking Laws (Amendment) Act, 2025 redefined the fortnight as the 1st–15th and the 16th–last day of each month, from 15 December 2025.
- **Penalty:** a shortfall attracts penal interest linked to the Bank Rate.

A higher CRR locks up more money, shrinks loanable funds and lowers the money multiplier (Chapter 8); a lower CRR does the reverse. Because even a small change moves lakhs of crores at once and hits every bank alike, the CRR is a blunt tool, and banks dislike it as an unpaid "tax" on deposits. The RBI therefore uses it sparingly: to release or absorb large, lasting amounts of liquidity, not to fight inflation week to week, which is the repo rate's job.

CRR over the Years

In the early 1990s the CRR stood at 15% and the SLR at 38.5%, so over half of every deposit was pre-empted (locked away before the bank could lend it). Following the Narasimham Committee (1991) both were brought down steadily. Recent moves show the CRR used both ways.

The latest cut was announced on 6 June 2025: **CRR reduced from 4% to 3%** in four equal steps of 25 basis points (a basis point, bp, is one-hundredth of a percentage point) from the fortnights beginning 6 September, 4 October, 1 November and 29 November 2025. The RBI used it, alongside bond purchases, to ease tight liquidity and to help banks cut lending rates.

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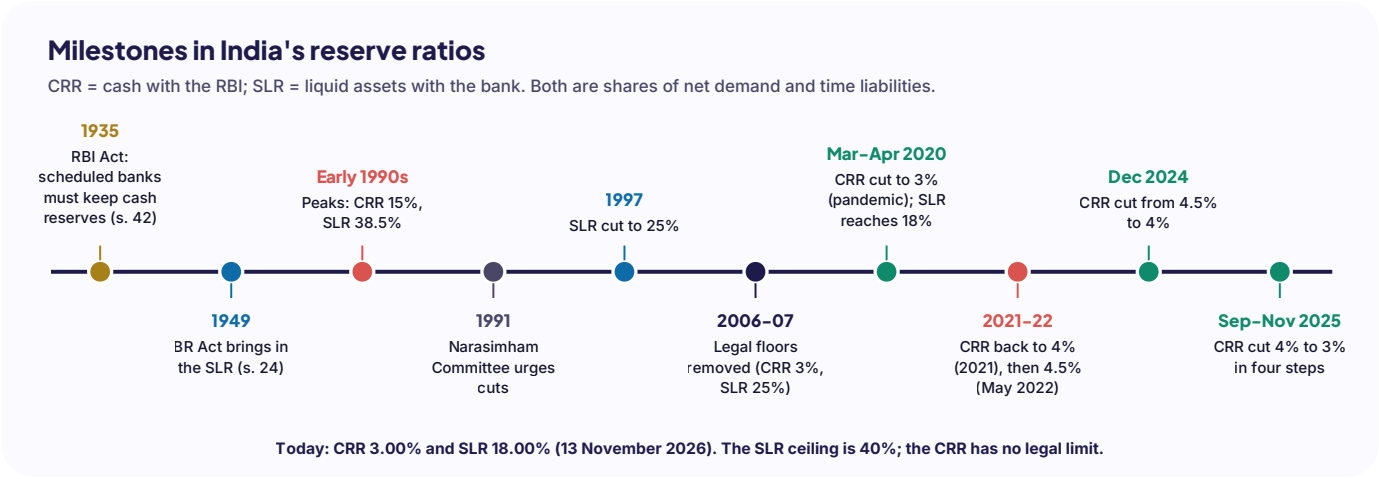


Fig. 12.3 Reserve ratios: from over half of deposits pre-empted in the early 1990s to CRR 3% and SLR 18% today.

WORKED EXAMPLE WHAT A 1-POINT CRR CUT RELEASES

Take a bank with NDTL of ₹10,000 crore that lends at 9% a year.

ITEM	CRR 4%	CRR 3%
Cash locked with the RBI	₹400 crore	₹300 crore
Interest lost on locked cash (at 9%)	₹36 crore a year	₹27 crore a year
Money freed for lending		₹100 crore, and ₹9 crore a year of extra income

For the whole system, the RBI estimated that the 2025 cut (100 bps) released about **₹2.5 lakh crore** of lendable cash, implying an NDTL base of about ₹250 lakh crore.

The RBI also **exempts** chosen deposits from CRR and SLR to steer funds: in June 2026 it exempted fresh 3–5-year FCNR(B) deposits to attract dollars (Section 08).

CONCEPT: LIQUIDITY OVERHANG AND THE INCREMENTAL CRR

A **liquidity overhang** is a situation in which banks hold far more money than borrowers want, so money-market rates fall below the policy rate and cheap money can feed inflation. (In a *liquidity trap*, Chapter 8, extra money fails to lower rates at all.) Twice the RBI met a sudden flood of deposits with a temporary, interest-free **incremental CRR (I-CRR)**, a reserve requirement on the **increase** in deposits only:

- **2016:** after demonetisation, 100% I-CRR on the rise in NDTL between 16 September and 11 November 2016, withdrawn within weeks.
- **2023:** after the ₹2000 note was withdrawn on 19 May 2023 and most notes came back as deposits, a 10% I-CRR on the rise in NDTL between 19 May and 28 July 2023, from 12 August 2023. It locked up about ₹1 lakh crore and was released in stages by 7 October 2023.

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03 Statutory Liquidity Ratio (SLR)

The **statutory liquidity ratio** is the share of NDTL that a bank must hold **with itself** in specified liquid assets. It is **18.00% of NDTL** (since April 2020).

- **Eligible assets:** cash, gold valued at no more than its market price, and unencumbered approved securities: Central government bonds (G-secs), treasury bills (T-bills) and State Development Loans (SDLs). Securities already pledged in a repo do not count.
- **Legal basis:** Section 24 of the Banking Regulation Act, 1949. The ceiling is **40%** of NDTL; the old floor of 25% was removed by a 2007 amendment.
- **Earns income:** unlike CRR cash, SLR bonds pay interest, so SLR is a smaller burden on banks.

The SLR serves three purposes: it keeps a liquidity cushion so banks can meet sudden withdrawals; it limits how much banks can lend; and it creates a ready, captive demand for government bonds. The last purpose is criticised as **financial repression**, since it pushes savers' money into government debt at below-market rates. That is why the Narasimham Committee urged a cut, and the SLR fell from 38.5% in the early 1990s to 25% in 1997 and to 18% by 2020. Banks now voluntarily hold government bonds well above 18% because they need them as collateral and as high-quality liquid assets under the Basel III liquidity rules (Chapter 17).

A cut in the SLR lets banks move money from bonds into loans, so they **may cut lending rates**. It does not by itself add or remove cash in the banking system, so its effect on liquidity and growth is gradual, never drastic. Deposit-taking non-banking financial companies (NBFCs) face a similar rule: they must keep 15% of public deposits in liquid assets under Section 45-IB of the RBI Act. The SLR does **not** apply to non-deposit-taking NBFCs, and the CRR applies to **no** NBFC.

COMMON CONFUSION: CRR VS SLR

BASIS	CRR	SLR
Kept where	With the **RBI**	With the **bank itself**
Form	Cash balance only	Cash, gold, G-secs, T-bills, SDLs
Interest	None	Yes, on bonds
Law	Section 42, RBI Act 1934	Section 24, BR Act 1949
Legal limits	None (since 2006)	Maximum 40%, no minimum
Rate today	3.00% of NDTL	18.00% of NDTL
Main effect	Changes banks' free cash (liquidity) and the money multiplier	Changes the split between bonds and loans; supports government borrowing

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PRELIMS TRAP WHAT STATUTORY RESERVES ARE FOR

- CRR and SLR together are called **statutory reserve requirements** (or variable reserve ratios). In monetary policy their purpose is to let the central bank **control the amount of credit** banks can create.
- They are **not** meant to stop banks making "excessive profits", and the CRR is **not** vault cash: a bank's day-to-day cash in its tills is separate and does not count towards CRR.
- Depositors' safety rests mainly on prudential regulation and deposit insurance (Chapter 17), **not** on reserve ratios, though the SLR does add a liquidity cushion.
- To meet SLR a bank need **not** hold cash only; bonds and gold also qualify.

04 Repo and Reverse Repo

START HERE A PLEDGE THAT IS BOUGHT BACK

A shopkeeper short of cash for a week pledges his gold chain with a lender, takes ₹50,000, and a week later pays back ₹50,000 plus interest to get the chain back. A bank short of cash does the same with the RBI, except the "gold chain" is a government bond. Formally the bank sells the bond to the RBI today and agrees to buy it back later at a slightly higher price. The difference is the interest, and its yearly rate is the **repo rate**.

A **repo** (repurchase agreement, also called a **ready forward** transaction) is a short-term loan in which the borrower sells securities and agrees to repurchase them on a set date at a set price. The **repo rate** is the rate at which the RBI lends to eligible institutions against government securities. It is the **policy rate** of India, fixed by the MPC: **5.50%** from 7 October 2026.

- **Collateral:** Central government securities, T-bills and SDLs, valued with a **haircut** (the RBI lends a little less than the bonds' market value as a safety margin).
- **SLR bonds:** a bank may pledge only bonds held **over and above** its SLR requirement; dipping into SLR is allowed only under the MSF.
- **Who can borrow:** scheduled commercial banks (including small finance banks, and regional rural banks since December 2020), eligible scheduled co-operative banks, and standalone primary dealers (firms licensed to deal in government securities). NBFCs in general **cannot** use the RBI's repo window.
- **Fixed or variable:** the daily **fixed-rate** repo window was withdrawn in February 2020. The RBI now lends mainly through **variable rate repo (VRR)** auctions: it announces an amount and banks bid; the rate is set by the bids, at or above the repo rate. Term repos of longer tenors were introduced in October 2013.

The repo rate is not the **neutral rate**: the theoretical **real** policy rate (the rate minus expected inflation) that neither stimulates nor restrains an economy growing at its potential with stable inflation (Chapters 4 and 11). It cannot be observed, and the RBI sets no official number for it (staff studies only estimate it). **NAIRU** (non-accelerating inflation rate of unemployment) is an unemployment rate, not an interest rate.

Reverse Repo

A **reverse repo** is the mirror image: the RBI **borrows** surplus money from banks and gives government securities as collateral. Seen from the RBI, it absorbs liquidity. The **fixed rate reverse repo (FRRR)** has stood

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at **3.35%** since 22 May 2020. It does **not** move with the repo rate and is kept in the toolkit for use at the RBI's discretion; the floor of the system is now the SDF (next section), where most surplus money goes. When the RBI itself wants to absorb for a fixed term, it runs **variable rate reverse repo (VRRR)** auctions, whose rate lies between the SDF and repo rates.

WORKED EXAMPLE THE COST OF A 7-DAY REPO

A bank borrows ₹100 crore from the RBI for 7 days at the repo rate of 5.50%, pledging bonds worth a little more (the haircut).

STEP	VALUE
Interest = 100 × 5.50% × 7 ÷ 365	₹0.1055 crore
Repurchase price paid on day 7	₹100.1055 crore (₹10.55 lakh of interest)

A 25-basis-point repo hike would raise the cost of the same deal by about ₹48,000. Small per deal, but it changes what every bank pays at the margin for money.

COMMON CONFUSION: REPO VS REVERSE REPO

- **Repo:** RBI **lends**, bank gives bonds, liquidity is **injected**. Raising the repo rate makes bank funds dearer: a **tightening** signal.
- **Reverse repo:** RBI **borrows**, RBI gives bonds, liquidity is **absorbed**. Raising its rate tempts banks to park money with the RBI rather than lend.
- Both names are from the **counterparty's** side: in a "repo" the bank sells and repurchases; in a "reverse repo" the bank buys and resells.
- A **market repo** (between banks, mutual funds and companies, including tri-party repo or TREPS) is borrowing in the money market, **not** an RBI policy tool (Chapter 19).

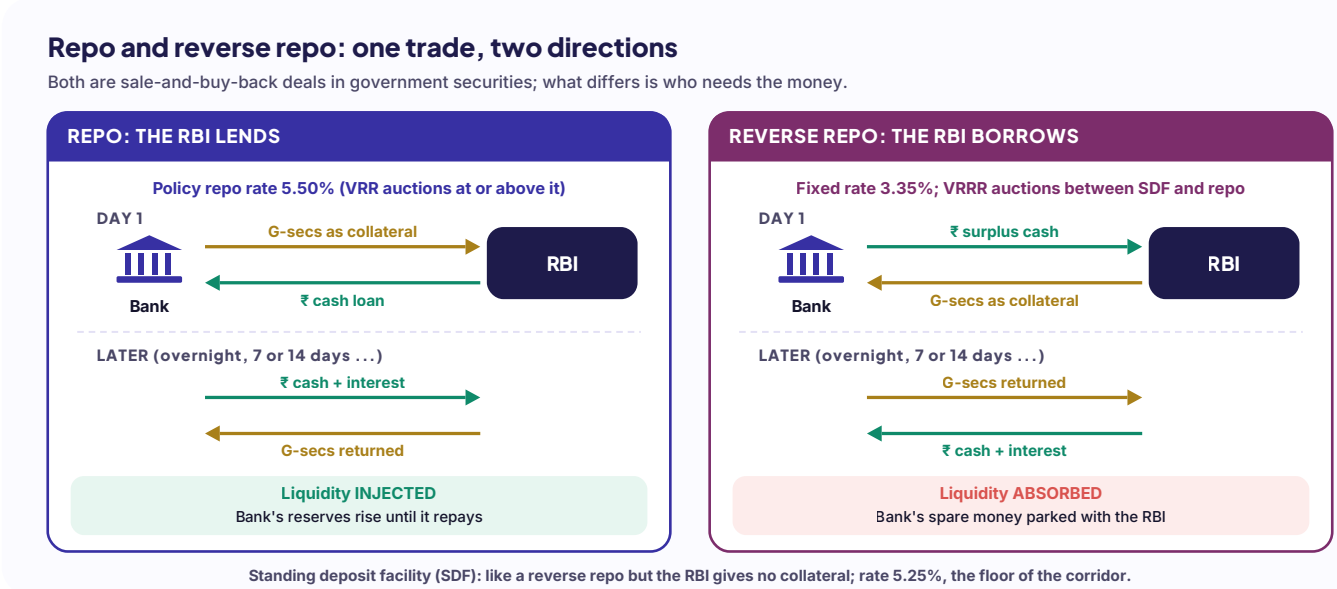


Fig. 12.4 Repo and reverse repo are the same two-leg trade seen from opposite sides: one injects money, the other absorbs it.

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05 The LAF Corridor: SDF, MSF, Bank Rate

START HERE **A HIGHWAY WITH CRASH BARRIERS**

Picture the overnight interest rate as a car on a highway. The RBI wants it in the middle lane, at the repo rate. Two crash barriers stop it from leaving the road: no bank needs to lend overnight for less than the RBI's deposit rate, because it can always park money with the RBI; and no bank needs to borrow for more than the RBI's emergency lending rate, because it can always borrow from the RBI. Those barriers, 25 basis points on either side of the repo rate, form the **policy corridor**.

The **Liquidity Adjustment Facility (LAF)**, introduced in June 2000, is the framework through which the RBI lends to and borrows from banks every day to adjust liquidity. It now has a **symmetric corridor** of 50 basis points: the SDF rate (25 bps below repo) is the floor, the repo rate the middle and the MSF rate (25 bps above repo) the ceiling, with the Bank Rate equal to the MSF rate.

Standing Deposit Facility (SDF)

The **SDF** lets eligible banks deposit surplus money with the RBI overnight and earn interest **without** the RBI giving any collateral in return. It was proposed by the *Urjit Patel Committee* (2014), made legal by inserting Section 17(1A) in the RBI Act through the Finance Act, 2018, and launched on **8 April 2022** at 3.75% (repo then 4%), when it replaced the fixed rate reverse repo as the **floor** of the corridor.

Why add it? A reverse repo needs the RBI to hand over government securities, and the RBI's stock of bonds limits how much it can absorb. Without collateral, the SDF can absorb any amount, which matters when inflows of dollars or deposits create a huge surplus. The SDF is a **standing facility**: available on demand at the bank's choice, with no limit on amount, every day from 7:00 pm to 11:59 pm. SDF balances count towards a bank's SLR but **not** its CRR.

Marginal Standing Facility (MSF)

The **MSF**, started in May 2011, is the RBI's overnight emergency window. A scheduled bank may borrow at the MSF rate against its excess securities and may **dip into its SLR** holdings by up to **2% of NDTL**. Its rate is above the repo rate, so banks use it only when the market and the repo window cannot meet their need; it is a standing facility available at the bank's discretion. The MSF rate was once 100 basis points above repo, and in July 2013, to defend a falling rupee, the RBI briefly widened the gap to 300 basis points, which shows that the corridor's width is a policy choice, not a law.

Bank Rate

The **Bank Rate** is defined in **Section 49 of the RBI Act** as the standard rate at which the RBI is prepared to buy or rediscount bills of exchange or other eligible commercial paper. It was long the main signalling rate and was meant for longer-term lending. With the arrival of the repo window it became largely dormant, and since February 2012 it has been aligned with the MSF rate. Today it matters mainly as a **reference rate**: penal interest on CRR and SLR shortfalls and several other charges are linked to it. A higher Bank Rate signals **dear (tight) money**; a lower one, more liquidity.

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How the Corridor Has Changed

FROM	FLOOR	CEILING	WIDTH
May 2011	Reverse repo = repo − 100 bps	MSF = repo + 100 bps	200 bps
April 2016	Reverse repo = repo − 50 bps	MSF = repo + 50 bps	100 bps
April 2017	Reverse repo = repo − 25 bps	MSF = repo + 25 bps	50 bps
2020 (pandemic)	Reverse repo cut to 3.35% (repo − 65 bps)	MSF = repo + 25 bps	90 bps, asymmetric
8 April 2022 onwards	**SDF = repo − 25 bps**	**MSF = repo + 25 bps**	**50 bps**

The LAF corridor, 13 November 2026

The RBI keeps the overnight call rate (WACR) between its deposit floor and its lending ceiling.

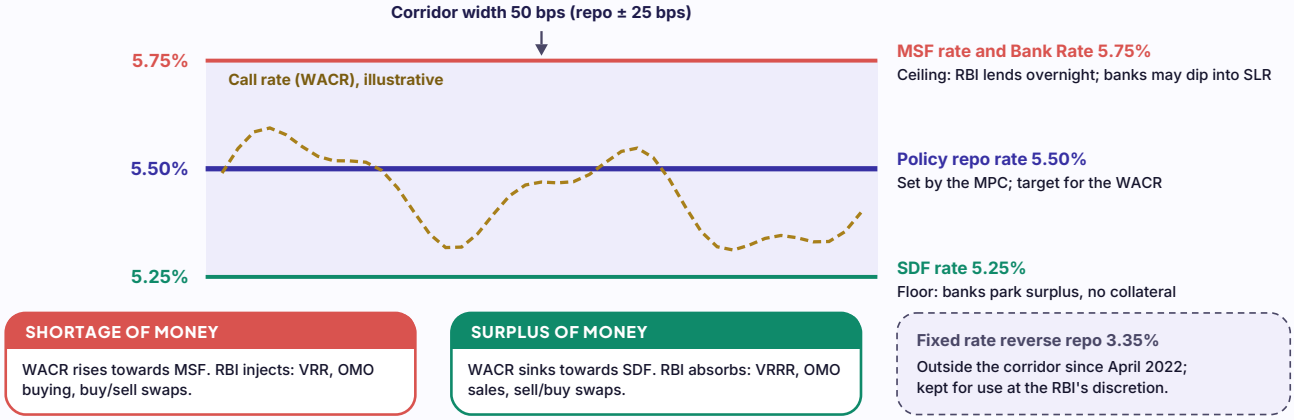


Fig. 12.5 The LAF corridor on 13 November 2026: the SDF floor and MSF ceiling hold the call rate near the 5.50% repo rate.

DATA BOX POLICY RATES AND RESERVE RATIOS, 13 NOVEMBER 2026

RATE OR RATIO	LEVEL	MOVES WITH REPO?
Policy repo rate	**5.50%**	Set by MPC (raised 25 bps on 7 October 2026)
Standing deposit facility rate	5.25%	Yes (repo − 25 bps)
Marginal standing facility rate	5.75%	Yes (repo + 25 bps)
Bank Rate	5.75%	Yes (equal to MSF)
Fixed rate reverse repo	3.35%	No (unchanged since May 2020)
Cash reserve ratio	3.00% of NDTL	No, set by RBI
Statutory liquidity ratio	18.00% of NDTL	No, set by RBI

Source: RBI, Resolution of the Monetary Policy Committee, 7 October 2026, and "Current Rates", RBI, 13 November 2026.

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CONCEPT: THE OPERATING TARGET

The MPC sets the repo rate, but what the RBI steers each day is the **weighted average call rate (WACR)**: the amount-weighted average rate at which banks lend to one another overnight, without collateral, in the call money market. The WACR has been the **operating target** since May 2011, and the 2025 review retained it. When banks are short of money the WACR rises towards the MSF rate; when they are flush, it sinks towards the SDF rate. The RBI supplies or absorbs liquidity to keep the WACR near the repo rate, because T-bill, bond and loan rates take their cue from it.

WORKED EXAMPLE WHY THE CALL RATE STAYS INSIDE THE CORRIDOR

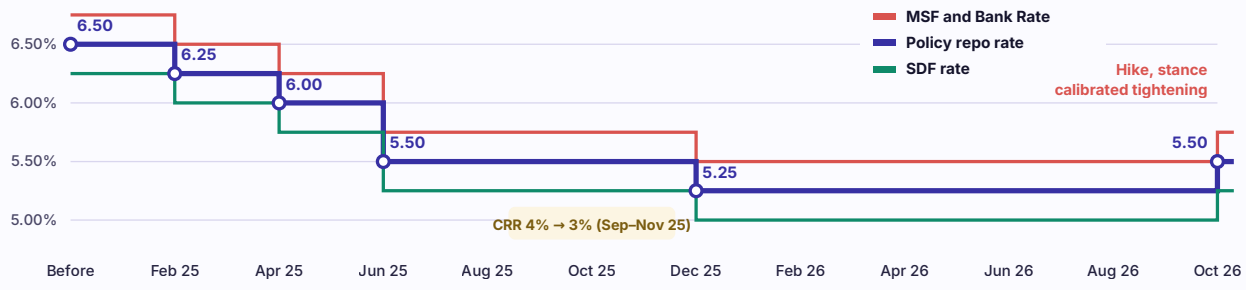
Tonight Bank A has ₹500 crore to spare and Bank B is ₹500 crore short.

CHOICE	OVERNIGHT INTEREST ON ₹500 CRORE
A parks at SDF 5.25%	earns ₹7.19 lakh
B borrows at MSF 5.75%	pays ₹7.88 lakh
A lends to B at 5.50%	A earns, and B pays, ₹7.53 lakh
Result	A will not lend below 5.25%; B need not pay above 5.75%

Both gain by dealing in the call market at any rate inside the corridor; where exactly it settles depends on how much spare money the system has. The ceiling holds only for a bank with bonds to pledge at the MSF.

The corridor moves as one block: policy rates, 2025–2026

Rates after each MPC decision; SDF = repo − 25 bps, MSF and Bank Rate = repo + 25 bps.



Source: RBI, MPC resolutions, February 2025 to 7 October 2026. 'Before' = rate from February 2023. Next MPC meeting: 2–4 December 2026.

Fig. 12.6 The corridor moves as one block: 125 bps of cuts in 2025, a pause, then a 25 bps hike on 7 October 2026.

◆ PRELIMS TRAP FLOOR, CEILING AND DATES

- The SDF (**April 2022**) replaced the fixed rate reverse repo as the **floor**; the FRRR (3.35%) still exists.
- MSF and SDF are **standing** facilities (banks' choice); VRR and VRRR auctions are at the **RBI's** discretion.
- The Bank Rate is **not** the repo rate; it equals the MSF rate.
- An **expansionary** policy cuts the repo rate, Bank Rate, CRR or SLR; it would **never** raise the MSF rate.

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COMMON CONFUSION: THE FOUR RBI WINDOWS

FEATURE	REPO	MSF	SDF	REVERSE REPO
Lender	RBI	RBI	Banks	Banks
Collateral	Bank's G-secs	Bank's G-secs, even SLR	None	RBI's G-secs
Rate	5.50% or more (VRR)	5.75%	5.25%	3.35%; VRRR by bids
Choice	RBI's (auctions)	Bank's	Bank's	RBI's
Role	Policy rate	Ceiling	Floor	Absorption tool

06 Managing Day-to-Day Liquidity

Liquidity here means the banking system's spare cash: balances with the RBI beyond what the CRR requires. It changes every day for reasons outside the RBI's policy decisions:

- Cash withdrawals at festivals and elections (drain)
- Tax payments into government accounts (drain)
- Government spending (inject)
- RBI buying dollars (inject) or selling them (drain)
- Deposit growth, which raises required CRR (drain)
- Maturing RBI repos, swaps and bonds (either way)

System liquidity is measured by the net position under the LAF: what banks have placed with the RBI (SDF, reverse repo, VRRR) minus what they have borrowed (repo, VRR, MSF). A positive figure is a **surplus**, a negative one a **deficit**. The RBI separates **transient** (frictional, short-lived) swings, met by short operations, from **durable** (lasting) gaps, met by OMOs, long-term repos, forex swaps or CRR changes.

The 2025 Liquidity Framework

On 30 September 2025 the RBI finalised a **revised liquidity management framework** after an internal working group review, reflecting 24×7 payment systems and "just-in-time" release of funds for government schemes.

- The overnight **WACR stays the operating target**, and the symmetric corridor (SDF and MSF 25 bps either side of repo) is retained.
- The **14-day VRR/VRRR** auction is no longer the main operation; transient liquidity is managed mainly through **7-day** and other auctions of overnight to 14 days, usually announced a day in advance.
- Durable tools stay: OMOs, long-term VRR/VRRR and forex swap auctions. The 90% daily CRR minimum continues.
- Standalone primary dealers have access to the SDF, overnight reverse repo and all repo operations.

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DATA BOX **DURABLE LIQUIDITY INJECTED IN 2025–26**

- Total durable injection: **₹13.78 lakh crore**, of which OMO purchases ₹7.39 lakh crore in 19 auctions (chart below).
- The repo rate fell 125 bps from February 2025, while the WACR averaged 7 bps **below** the repo rate in 2025-26.
- System liquidity averaged a daily surplus of ₹1.86 lakh crore; the SDF took 84.9% of all money banks placed with the RBI.

Source: RBI, Annual Report 2025-26, Chapter III (Tables III.1 and III.2), 29 May 2026.

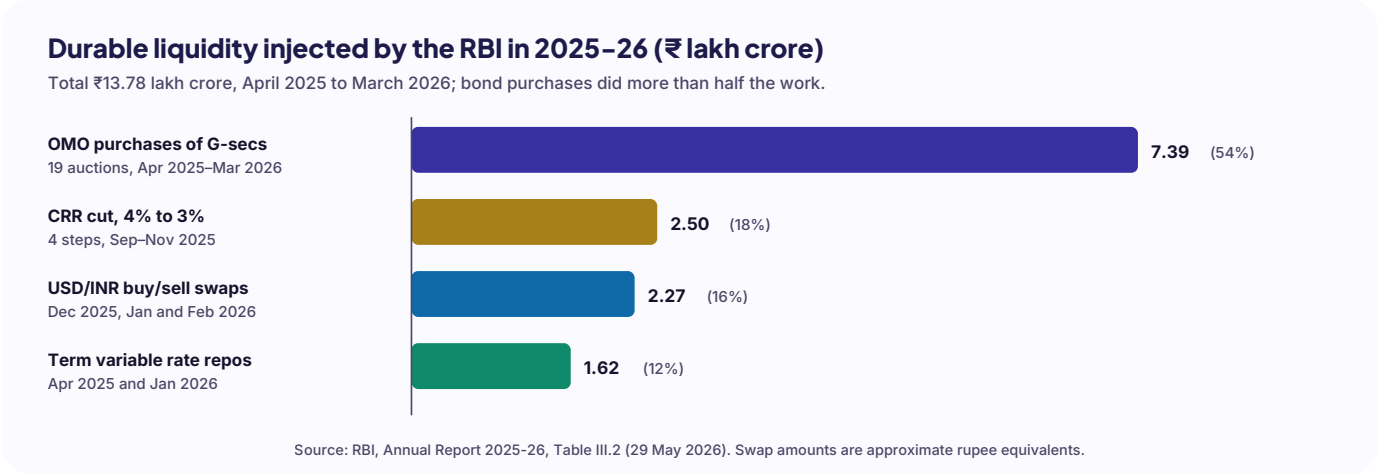


Fig. 12.7 2025-26 was a year of heavy liquidity injection: bond purchases did more than half the work.

In 2026-27 the problem reversed. Dollar inflows under the RBI's special swap window (explained under forex swaps below) pushed average daily absorption under the LAF to ₹3.21 lakh crore in April–mid-September 2026, from ₹1.43 lakh crore in the second half of 2025-26, even as a build-up of government cash balances drained some money. The RBI ran 51 VRRR auctions against 36 VRR auctions in that half-year and **sold** government bonds worth ₹1 lakh crore through OMOs in September, and ₹25,000 crore more in October.

07 Open Market Operations

START HERE **THE RBI AS A BUYER AND SELLER OF BONDS**

When the RBI buys a ₹1,000 crore government bond from a bank, it simply credits ₹1,000 crore to that bank's account with the RBI. That money did not exist a moment ago: the bank now has more reserves to lend. When the RBI sells a bond, the buyer pays from its RBI account, and that money disappears from the banking system. Buying adds money; selling removes it.

Open market operations (OMOs) are the purchase and sale of government securities by the RBI in the open (secondary) market, where existing bonds are traded, to adjust rupee liquidity. They come in two kinds:

- **Outright OMOs:** permanent purchases or sales, with no promise to reverse them; they change **durable** liquidity. In everyday usage "OMO" means these.
- **Repo OMOs:** purchases or sales with an agreement to reverse (repo and reverse repo); they change liquidity only for the deal's term.

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To fight inflation the RBI **sells** securities; to ease a liquidity shortage or support growth it **buys**. OMO sales are limited by the stock of bonds the RBI holds. Since April 2006 the Fiscal Responsibility and Budget Management (FRBM) Act has barred the RBI from buying government securities in primary auctions except in special circumstances, so OMOs take place in the secondary market. In December 2025 the Governor stressed that OMO purchases aim at durable liquidity, not at bond yields.

◆ PRELIMS FACT WHAT CHANGES THE MONEY SUPPLY

- The central bank **buying** government securities from the public: money supply **rises**.
- The government **borrowing from the central bank** (for example, through ways and means advances): money supply **rises**, since new reserve money (Chapter 8) is created.
- The public **depositing currency** in banks: **no** change in broad money at first, only in its form (cash becomes deposits).
- The central bank **selling** securities: money supply **falls**.

Operation Twist

Bond prices and yields move in opposite directions: when a bond's price rises, its fixed interest is a smaller return on the higher price (Chapter 20). Companies price their bonds off G-sec yields, so lower long-term G-sec yields make long-term borrowing cheaper for firms and the government.

Operation Twist is a special OMO in which the central bank **simultaneously buys long-term and sells short-term** government securities. The amount of money in the system stays about the same, but long-term yields fall and short-term yields rise: the yield curve (the line of yields from short to long maturities) "twists" and flattens. The US Federal Reserve first used it in 1961. The RBI used it from **December 2019**, announcing purchases of a 10-year bond and sales of short-dated ones of ₹10,000 crore each in its first round, because repo cuts in 2019 had not lowered long-term borrowing costs much. Its aim was cheaper long-term credit and better transmission, **not** inflation control.

WORKED EXAMPLE WHY BUYING BONDS LOWERS YIELDS

BOND PAYING ₹7 A YEAR ON FACE VALUE ₹100	CURRENT YIELD (₹7 ÷ PRICE)
Market price ₹100	7.00%
RBI buying lifts the price to ₹104	6.73%
RBI selling pushes the price to ₹96	7.29%

G-SAP and Quantitative Easing

Under the **G-sec Acquisition Programme (G-SAP)** in 2021, the RBI pre-announced its bond purchases: ₹1 lakh crore in April–June 2021 (G-SAP 1.0) and ₹1.2 lakh crore in July–September 2021 (G-SAP 2.0). The promise calmed the bond market amid heavy post-pandemic borrowing. It was paused in October 2021.

Quantitative easing (QE) is massive bond buying by a central bank whose policy rate is already near zero, as by the US Federal Reserve after 2008 and in 2020. Slowing such purchases is **tapering** (the 2013 "taper tantrum" hit the rupee, Chapter 34); shrinking the bond holdings is quantitative tightening (QT). Some central

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banks went further, to negative deposit rates (euro area, Japan). "Helicopter money", a direct handout of new money to the public, is an idea associated with Milton Friedman.

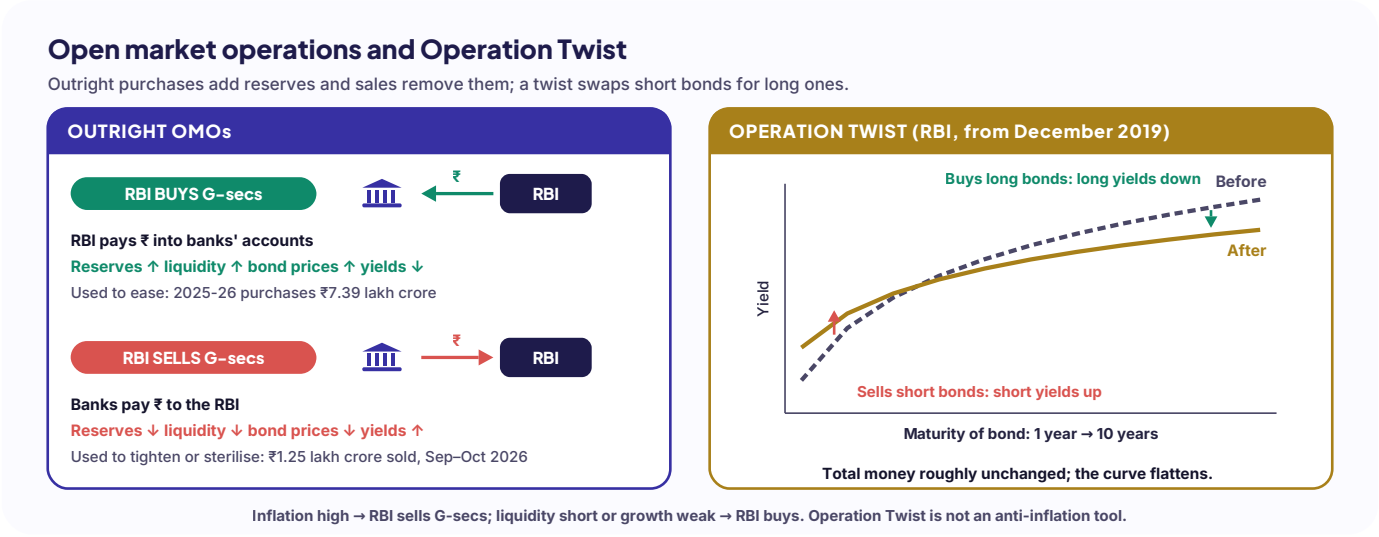


Fig. 12.8 OMO purchases add reserves and sales remove them; Operation Twist flattens the yield curve.

08 Sterilisation, MSS and Forex Swaps

START HERE MOPPING UP AFTER BUYING DOLLARS

Say foreign investors bring in $10 billion and the RBI buys the dollars to stop the rupee rising too fast. It pays about ₹94,000 crore of newly created rupees into banks, money that could fuel inflation. So it sells government bonds of a similar amount and pulls the rupees back. The dollars stay in the reserves; the extra rupees leave the economy. That clean-up is **sterilisation**.

Sterilisation is the action a central bank takes to neutralise the effect of its foreign exchange operations on domestic money supply. When it buys foreign currency, new rupees flow into banks, and it absorbs them back (OMO sales, MSS bonds, VRRR or SDF, or a CRR increase). When it sells foreign currency to defend the rupee, rupees drain out, and it may put them back through OMO purchases or repos.

The same logic explains RBI behaviour in currency markets. If the rupee is **depreciating** rapidly, the RBI is likely to **sell dollars**. If interest rates in the US or Europe fall, money flows into India in search of higher returns, and the RBI is likely to **buy dollars** to limit the rupee's rise and add to reserves. If inflation is high, the RBI **sells**, not buys, government securities.

Market Stabilisation Scheme (MSS)

OMO sales are limited by the RBI's own stock of bonds. The **Market Stabilisation Scheme**, started in **April 2004** under an agreement between the Government and the RBI, solved this. The government issues special treasury bills and dated securities purely to absorb surplus liquidity from large capital inflows.

- The money sits in a separate **MSS account** with the RBI; the government **cannot** spend it.
- The government bears the **interest cost**, which is the fiscal price of sterilisation.

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- A ceiling on MSS issuance is agreed between the government and the RBI. After demonetisation in 2016 it was raised to ₹6 lakh crore to absorb the flood of returned notes.

Since the SDF can absorb unlimited money without collateral, the MSS is now kept in reserve.

Foreign Exchange Swaps

In a **USD/INR buy/sell swap** the RBI buys dollars from banks now (paying rupees) and agrees to sell them back later: rupee liquidity is **injected** for the swap's term, often three years. A **sell/buy swap** does the reverse and **absorbs** rupees. The RBI first used a long-term buy/sell swap ($5 billion, three years) in March 2019 and used them heavily in 2025-26 ($5 billion in December 2025, more in January and February 2026).

COMMON CONFUSION: BUY/SELL VS SELL/BUY SWAP

- **Buy/sell** (RBI buys dollars first): rupees go **into** banks; forex reserves rise for the term (used in 2025-26).
- **Sell/buy** (RBI sells dollars first): rupees come **out** of banks; absorbs a surplus or meets dollar demand.
- A swap is **not** a permanent purchase: the second leg reverses it at an exchange rate fixed today, so the dollars gained carry an obligation to return them.

IN THE NEWS 2026: THE FCNR(B) SWAP WINDOW

With the rupee under pressure from the West Asia conflict and high oil prices, the RBI on 5 June 2026 offered to bear the full cost of hedging (insuring against exchange-rate changes) fresh 3–5-year **FCNR(B) deposits**, the foreign currency deposits of non-resident Indians, through a **special USD/INR swap**, and exempted them from CRR and SLR. A similar swap covered overseas borrowings by public sector firms and banks. The window opened on 8 June 2026 and closed a month early, on 31 August.

- FCNR(B) deposits mobilised: **$132.98 billion**; total inflows under the facility $143.6 billion by 18 September 2026, far above the $34 billion of a similar 2013 scheme.
- Because banks swapped these dollars with the RBI for rupees, system liquidity surged, forcing VRRR auctions and ₹1.25 lakh crore of OMO sales in September–October 2026.
- Critics point to the RBI's cost and the large repayments due in 2029–31; supporters credit it with calming the rupee and lifting reserves above $700 billion.

09 Special Windows: LTRO, TLTRO and More

When the normal repo window is not enough, the RBI opens special, time-bound windows. Most date from 2020–21, when the pandemic froze credit markets.

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WINDOW	WHEN	WHAT IT DID
LTRO (long-term repo operations)	February 2020	Up to ₹1 lakh crore of 1- and 3-year funds at the repo rate, to lower longer-term rates
TLTRO (targeted LTRO)	March–April 2020	3-year funds that banks had to invest in corporate bonds and commercial paper; TLTRO 2.0 was aimed at NBFCs and microfinance institutions but drew a weak response
On-tap TLTRO	October 2020	Funds on demand for lending to five chosen sectors, later 26 stressed sectors and NBFCs
Mutual fund facility; refinance to NABARD, SIDBI, NHB	April 2020	₹50,000 crore for mutual funds after a fund house shut six debt schemes; refinance for farm, small business and housing credit
SLTRO (special LTRO) and on-tap health and contact-intensive windows	May–June 2021	3-year repo for small finance banks; ₹50,000 crore for health services; ₹15,000 crore for hotels, tourism and similar sectors

In the same period the RBI cut the reverse repo rate to **3.35%** (May 2020), well below the repo rate of 4%, so that banks earned little by parking idle money with it and had more reason to lend. The CRR was cut to 3% in March 2020 and the MSF limit was temporarily raised from 2% to 3% of NDTL. These windows were wound down in 2021-22 and the normal corridor was restored in April 2022.

10 Qualitative and Selective Tools

START HERE AIMING CREDIT, NOT JUST TURNING THE TAP

A repo hike makes every loan dearer, the farmer's as well as the speculator's. Sometimes the RBI wants something narrower: cool borrowing against gold or shares, or fast-growing personal loans, without touching tractor loans. For that it uses tools that act on particular loans, sectors or lenders, controlling *where* credit goes rather than *how much* there is.

Selective Credit Controls

- **Selective credit control**: since 1956 the RBI, using powers under the Banking Regulation Act, has from time to time restricted bank advances against "sensitive" commodities such as foodgrains, oilseeds, sugar and cotton, to stop hoarding.
- **Credit Authorisation Scheme** (1965–1988): banks needed the RBI's prior approval for large loans to a single borrower.
- **Credit rationing**: ceilings on the total credit a bank may give, or on credit for a purpose; tried in the 1970s for non-food credit.
- **Differential interest rates**: for example the Differential Rate of Interest scheme (1972), which gave poor borrowers loans at 4%.
- **Consumer credit regulation**: changing down-payment and repayment rules for durables and vehicles.

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Many old controls were dropped after 1991 because they were hard to monitor and easy to evade. Directed credit lives on as **priority sector lending** (40% of adjusted net bank credit for most banks; details in Chapter 18).

Margin Requirements and Loan-to-Value

The **margin** is the part of a collateral's value that the lender may **not** lend against; the **loan-to-value (LTV) ratio** is the share it may lend. A lower LTV (higher margin) curbs borrowing against that asset; a higher LTV encourages it.

- **Gold loans:** LTV was 75%, raised to 90% for banks from August 2020 to March 2021 in the pandemic. The RBI's gold and silver lending directions (6 June 2025, in force by 1 April 2026) set tiered caps for consumption loans: **85%** up to ₹2.5 lakh, **80%** for ₹2.5–5 lakh and **75%** above ₹5 lakh, maintained through the loan's life.
- **Home loans:** maximum LTV of 90% up to ₹30 lakh, 80% for ₹30–75 lakh and 75% above.
- **Loans against shares:** proposed in October 2025 and in force from 1 July 2026, the cap on bank loans against shares and other eligible securities rose from ₹20 lakh to ₹1 crore per person and on IPO financing from ₹10 lakh to ₹25 lakh, both counted across the whole banking system.

Risk Weights

A higher **risk weight** on a type of loan forces banks to hold more capital against it (Chapter 17). In November 2023 the RBI raised risk weights on unsecured consumer credit and bank loans to NBFCs by 25 percentage points to cool fast growth; in February 2025 it rolled back the rise on bank loans to NBFCs.

Moral Suasion, Publicity and Direct Action

- **Moral suasion**: persuading banks through letters, meetings and speeches, without penalties, for instance to pass on rate cuts or cut intermediation costs.
- **Publicity**: speeches and reports that shape public opinion and so press banks to act.
- **Direct action**: penalties or business curbs on entities that ignore RBI directions, under the RBI Act, Banking Regulation Act, FEMA and other laws.

◆ PRELIMS TRAP SELECTIVE OR GENERAL?

- CRR is a **general** tool and is **not** an instrument of selective credit control; regulation of consumer credit, rationing of credit and margin requirements are selective.
- Priority sector norms apply to **banks only**, not to NBFCs.
- Moral suasion carries **no** legal penalty; direct action does.

11 Using the Toolkit: Tighten or Ease

When inflation runs above target the RBI follows a **tight** (dear, hawkish, contractionary) policy; when growth is weak and inflation low it follows an **easy** (cheap, dovish, expansionary) policy (stance in Chapter 11). The table at the end of this section sums up how each tool is used; first, what no tool can do.

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Limits of the Toolkit

- **Supply shocks**: a poor monsoon or an oil spike raises prices that no rate change can fix; policy can only stop them spreading into wages and expectations.
- **Fiscal pressure**: large deficits and government borrowing can push up rates and blunt policy (Chapters 27 and 31).
- **Weak transmission**: banks may be slow to pass rate changes to loans and deposits, and informal moneylenders lie outside the system (Chapter 13).
- **Uneven effects**: the **Cantillon effect**, named after the 18th-century economist Richard Cantillon, holds that those who receive new money first, often asset owners, gain before prices rise for everyone else.
- **Black swan events**, rare and unforeseen shocks such as 2008 or 2020 (a term popularised by Nassim Nicholas Taleb), can overwhelm normal tools. The ideal is a **soft landing**: inflation brought down without a recession, rather than a **hard landing** with sharp job losses.

TOOL	TO FIGHT INFLATION (TIGHTEN)	TO REVIVE GROWTH (EASE)	EFFECT OF EASING ON LIQUIDITY
Repo, SDF, MSF, Bank Rate	Raise	Cut	Cheaper borrowing for banks
CRR	Raise	Cut	Direct, large injection
SLR	Raise	Cut	More lendable funds
OMOs	Sell G-secs	Buy G-secs	Durable injection
VRR / VRRR auctions	More VRRR	More VRR	Short-term injection
FX swaps	Sell/buy	Buy/sell	Injection for the swap term
LTV / margins, risk weights	Lower LTV, raise risk weights	Raise LTV, lower risk weights	More credit to chosen sectors

Real decisions mix tools: in October 2026 the RBI raised the repo rate and kept absorbing surplus money so the call rate would rise to it. The policy rate signals the direction; the liquidity tools make the signal stick.

CONNECTING THE DOTS FROM A RATE DECISION TO YOUR EMI

- The MPC sets the repo rate to keep CPI inflation near 4% (Chapter 11)
- The corridor, VRR/VRRR, OMOs and swaps pull the call rate to the repo rate (this chapter)
- Money market and bond yields follow the call rate (Chapters 19 and 20)
- Banks reset repo-linked loans and deposit rates (Chapter 13)
- Demand, the rupee and inflation feed the next MPC decision (Chapters 4 and 34)

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USING THIS CHAPTER IN MAINS

For questions on inflation control, liquidity or the rupee, start by classifying the tools as general and selective, and price-based and quantity-based. Explain the corridor and the WACR operating target with the current rates, then show how the RBI combined tools in 2025-26 (repo cuts, CRR cut, ₹13.78 lakh crore of durable injection) and in 2026 mopped up FCNR(B) swap inflows (VRRR, OMO sales) before a rate hike. Weigh the CRR's bluntness against OMOs' precision. Close with the limits of monetary tools against supply shocks, and the need for fiscal and supply-side support.

Chapter 12 at a Glance

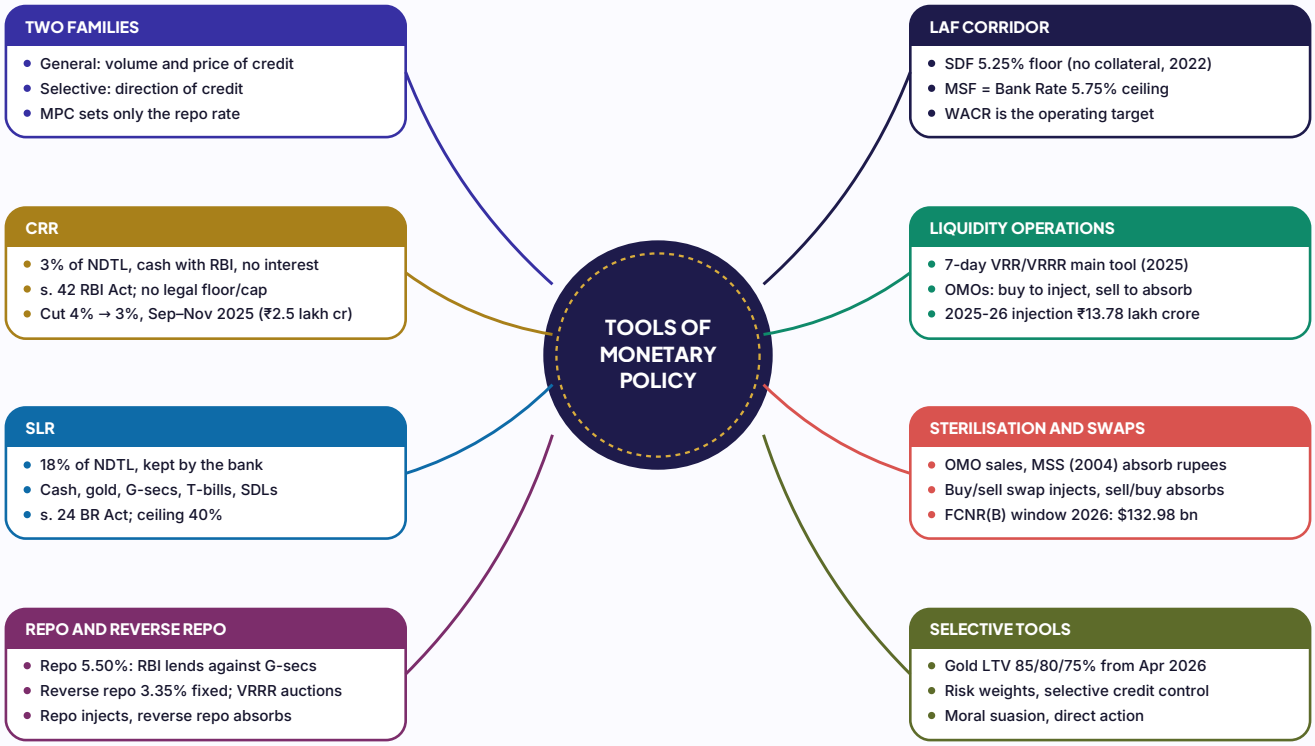


Fig. 12.9 Chapter 12 at a glance: the whole chapter on one page for quick revision.

Prelims Quick Revision

- **Quantitative vs qualitative tools**: quantitative tools change the volume and price of all credit; qualitative tools change its direction.
- **Who decides**: the MPC sets only the repo rate; CRR, SLR, OMOs, swaps and LTV limits are decided by the RBI.
- **CRR**: 3.00% of NDTL kept as cash with the RBI, no interest; Section 42, RBI Act; no legal floor or ceiling.
- **CRR cut 2025**: 4% to 3% in four 25 bps steps, September–November 2025, releasing about ₹2.5 lakh crore.
- **SLR**: 18.00% of NDTL held by the bank in cash, gold or approved securities; Section 24, BR Act; ceiling 40%.
- **Repo rate**: 5.50% from 7 October 2026; the RBI lends against government securities; the policy rate.

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- **LAF corridor**: SDF 5.25% (floor), repo 5.50%, MSF and Bank Rate 5.75% (ceiling); width 50 bps.
- **SDF**: deposit window without collateral; Section 17(1A) RBI Act (2018); floor of the corridor since 8 April 2022.
- **Fixed rate reverse repo**: 3.35% since May 2020; does not move with repo; outside the corridor.
- **MSF**: overnight window since May 2011; banks may dip into SLR up to 2% of NDTL.
- **Bank Rate**: Section 49, RBI Act; equal to the MSF rate since February 2012; used for penal rates.
- **Operating target**: the weighted average call rate (WACR), retained in the September 2025 framework review.
- **Revised liquidity framework (30 Sep 2025)**: 7-day VRR/VRRR replaced the 14-day auction as the main operation.
- **Durable injection 2025-26**: ₹13.78 lakh crore, including OMO purchases of ₹7.39 lakh crore.
- **Operation Twist**: buying long-term and selling short-term G-secs together to lower long yields; used by the RBI from December 2019.
- **Sterilisation**: absorbing the rupees created by RBI dollar purchases, through OMO sales, SDF/VRRR or MSS bonds (since April 2004).
- **FCNR(B) swap window 2026**: 8 June–31 August 2026; $132.98 billion of deposits; CRR and SLR exempt.
- **Gold loan LTV**: 85% up to ₹2.5 lakh, 80% up to ₹5 lakh, 75% above, in force by 1 April 2026.

Previous Year Questions

2023 Which one of the following activities of the Reserve Bank of India is considered to be part of 'sterilization'?

a. Conducting 'Open Market Operations'

b. Oversight of settlement and payment systems

c. Debt and cash management for the Central and State Governments

d. Regulating the functions of Non-banking Financial Institutions

Answer: (a). Sterilisation neutralises the rupee effect of forex operations, chiefly through OMO sales of government securities (Section 08).

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2022 With reference to the Indian economy, consider the following statements :
1. If the inflation is too high, Reserve Bank of India (RBI) is likely to buy government securities.
2. If the rupee is rapidly depreciating, RBI is likely to sell dollars in the market.
3. If interest rates in the USA or European Union were to fall, that is likely to induce RBI to buy dollars.
Which of the statements given above are correct ?

a 1 and 2 only
b 2 and 3 only
c 1 and 3 only
d 1, 2 and 3

Answer: (b). High inflation calls for selling, not buying, G-secs; the RBI sells dollars when the rupee falls fast and buys dollars when lower US or EU rates bring in capital (Section 08).

2020 If the RBI decides to adopt an expansionist monetary policy, which of the following would it not do?
1. Cut and optimize the Statutory Liquidity Ratio
2. Increase the Marginal Standing Facility Rate
3. Cut the Bank Rate and Repo Rate
Select the correct answer using the code given below :

a 1 and 2 only
b 2 only
c 1 and 3 only
d 1, 2 and 3

Answer: (b). Easing means cutting the SLR, Bank Rate and repo rate (1 and 3); raising the MSF rate makes borrowing dearer, so only 2 would not be done (Sections 05 and 11).

2015 When the Reserve Bank of India reduces the Statutory Liquidity Ratio by 50 basis points, which of the following is likely to happen?

a India's GDP growth rate increases drastically
b Foreign Institutional Investors may bring more capital into our country
c Scheduled Commercial Banks may cut their lending rates
d It may drastically reduce the liquidity to the banking system

Answer: (c). A lower SLR lets banks shift money from bonds to loans, so they may cut lending rates; it neither drains liquidity nor lifts growth “drastically”, and has no direct link with foreign investors (Section 03).

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2015 With reference to Indian economy, consider the following:
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

Answer: (c). Bank Rate and OMOs are RBI tools; public debt and public revenue belong to fiscal policy (Section 01).

2014 The terms 'Marginal Standing Facility Rate' and 'Net Demand and Time Liabilities', sometimes appearing in news, are used in relation to

a banking operations
b communication networking
c military strategies
d supply and demand of agricultural products

Answer: (a). MSF is the RBI's overnight window for scheduled banks, and NDTL is the deposit base on which CRR and SLR are levied: both are banking terms (Sections 02 and 05).

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

Answer: (a). The key accepts only 1: reserve ratios cap the credit banks can create. It rejects 2 (deposit safety rests on prudential rules and deposit insurance, though the SLR does add a liquidity cushion), 3 (profits are not the aim) and 4 (CRR is a balance with the RBI, not vault cash) (Section 03).

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2013 An increase in the Bank Rate generally indicates that the

a market rate of interest is likely to fall
b Central Bank is no longer making loans to commercial banks
c Central Bank is following an easy money policy
d Central Bank is following a tight money policy

Answer: (d). A higher Bank Rate makes RBI credit dearer and signals a tight (dear) money policy (Section 05).

2013 In the context of Indian economy, 'Open Market Operations' refers to

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

Answer: (c). OMOs are the purchase and sale of government securities by the RBI to adjust liquidity (Section 07).

2012 Which of the following measures would result in an increase in the money supply in the economy?
1. Purchase of government securities from the public by the Central Bank
2. Deposit of currency in commercial banks by the public
3. Borrowing by the government from the Central Bank
4. Sale of government securities to the public by the Central Bank
Select the correct answer using the codes given below:

a 1 only | b 2 and 4 only | **c 1 and 3** | d 2, 3 and 4

Answer: (c). 1 and 3 create new reserve money, so money supply rises; 2 only changes the form of money (cash becomes deposits); 4 withdraws money (Section 07).

2011 The lowering of Bank Rate by the Reserve Bank of India leads to

a More liquidity in the market
b Less liquidity in the market
c No change in the liquidity in the market
d Mobilization of more deposits by commercial banks

Answer: (a). A lower Bank Rate makes RBI credit cheaper and signals easy money, so liquidity in the market rises (Section 05).

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