KERALA ECONOMY
2024, VOL. 5, NO.4. pp 48-51

ISSN : 2583-4436

Monetary management and financial intermediation: Stability is the watchword

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Abstract

India's banking and financial sectors saw strong performance in FY24, with bank credit growth, improved asset quality, and low non-performing assets. The stock market also surged, with the Nifty 50 index up 26.8%, and India ranking fifth globally in market capitalization to GDP ratio. The insurance and pension sectors overgrew, supported by regulatory measures. However, the rise in retail investors raises concerns about speculation and unrealistic expectations. Firms must prioritize consumer interests, transparency, and long-term goals to ensure stability. Avoiding over-financialization while supporting economic growth will be key to sustaining this momentum.

Keywords: *Monetary policy, Financial Inclusion, Financialization, Capitalization.*

Introduction

The Economic Survey 2023-24 suggested a resilient and strong performance of India’s banking and financial sector amidst the geopolitical challenges, with the Central Bank maintaining steady policy rates to control inflation. The Russia-Ukraine conflict prompted monetary tightening, leading to increased lending and deposit rates, and significant growth in bank loans, particularly in personal loans and services. Capital markets thrived, with India ranking fifth globally in stock market capitalization to GDP ratio, supported by robust Digital Public Infrastructure (DPI) and the active roles of banks and microfinance institutions (MFIs) in enhancing financial inclusion. The economic survey's analysis is split into two parts: monetary developments focusing on liquidity conditions, and financial intermediation examining the banking sector's performance, the government's management of distressed assets via the Insolvency and Bankruptcy Code (IBC), and efforts towards digital financial inclusion and data protection.

Monetary developments

Monetary and credit conditions aligned with the policy stance, supporting domestic economic activity in FY24. The Monetary Policy Committee (MPC) maintained the policy repo rate at 6.5%, focusing on controlling inflation while promoting growth. Following a cumulative 250 basis point hike between May 2022 and February 2023, the MPC kept rates steady but remains ready to act if necessary. Key factors affecting monetary and credit conditions in FY24 included the withdrawal of Rs.2,000 banknotes, the HDFC and HDFC Bank merger, and the temporary imposition of incremental CRR (I-CRR). The return of Rs.2,000 notes to the banking system, with 97.87% returned by June 2024, and higher term deposit rates boosted aggregate deposits and broad money (M3). As a result, currency in circulation (CiC) growth slowed to 4.1% from 7.8% YoY, reflecting the impact of the banknote withdrawal.

During FY24, the RBI managed liquidity through two-way operations, conducting 17 Variable Rate Reverse Repo (VRRR) and seven Variable Rate Repo (VRR) auctions as primary measures, along with 49 fine-tuning operations. Banks also used the Marginal Standing Facility (MSF) amidst tight liquidity conditions, with the RBI allowing the reversal of liquidity facilities under the Standing Deposit Facility (SDF) and MSF even on weekends starting in December 2023. In response to rising surplus liquidity from the return of Rs.2,000 banknotes, the RBI introduced a temporary Incremental CRR (I-CRR) of 10% in August 2023, impounding Rs.1.1 lakh crore. The I-CRR was phased out by October 2023, easing liquidity ahead of the festival season. Despite these measures, the banking system experienced a liquidity deficit by mid-September, which persisted throughout FY24.

Lending and deposit rates of scheduled commercial banks (SCBs) increased in FY24, reflecting the delayed effects of policy rate hikes from May 2022 to February 2023 and reduced surplus liquidity. Between May 2022 and May 2024, external benchmark-based lending rates rose by 250 basis points, while the one-year median marginal-cost-of-funds-based lending rate increased by 175 basis points. This demonstrates the effective transmission of policy rate hikes to lending and deposit rates.

Financial intermediation

Financial development and economic growth are closely connected, with financial intermediation serving as the key mechanism linking the two. Financial intermediaries mobilize savings, extend credit, manage assets, and facilitate transactions, which are crucial for technological innovation and economic progress, as noted by economist Joseph Schumpeter. Additionally, financial intermediation encourages foreign capital inflows and supports inclusive economic growth by improving the allocation of savings and ensuring access to finance for all sectors, including vulnerable groups and small businesses. For sustained financial development, key stability indicators like Capital to Risk (Weighted) Assets Ratio (CRAR) and liquidity levels must be managed, along with strong regulatory policies and coordination among financial regulators.

Financial inclusion is essential for sustainable economic growth, poverty reduction, and reducing inequality, with the UN highlighting its importance in achieving the 2030 Sustainable Development Goals. India has made notable progress, increasing the percentage of adults with formal financial accounts from 35% in 2011 to 77% in 2021, which would have otherwise taken 47 years without targeted initiatives. Digitalization has significantly driven this financial inclusion, particularly through Digital Financial Inclusion (DFI), which seeks to provide affordable access to formal financial services for underserved populations. The India Stack—comprising identity, payment, and data governance layers—has been pivotal in this process, with Aadhaar simplifying KYC procedures and the Unified Payments Interface (UPI) dramatically increasing transaction values from Rs.0.07 lakh crore in FY17 to Rs.200 lakh crore in FY24, aided by the growth of smartphone usage.

The performance of microfinance institutions (MFIs) in FY23 was robust, with total assets reaching Rs.1.5 lakh crore, a 30% increase from the previous year, and demonstrating a return on assets (RoA) of 2.5% and a return on equity (RoE) of 12.2%. Indian MFIs also maintained a strong median capital adequacy ratio (CAR) of 26.5%, well above the 15% regulatory requirement. Meanwhile, following a turbulent FY23, global stock markets rebounded in FY24, with India's Nifty 50 index rising by 26.8%, contrasting with an 8.2% decline in the previous year. In the pension sector, the launch of the National Pension Scheme (NPS) and Atal Pension Yojana (APY) contributed to an 18% increase in total subscribers, reaching 735.6 lakh by March 2024, with APY subscribers accounting for 80% of this total. Despite improvements in gender and age demographics, about 92% of APY accounts are for a monthly pension of Rs. 1,000, reflecting the low-income status of the target population, which often prioritizes immediate consumption over savings.

Way forward

India's financial industry has made significant progress over the years, with domestic credit to the private sector rising from 50.6% of GDP in 2010 to 54.7% in 2021, and a decline in gross and net non-performing assets (NPAs) among SCBs, alongside improvements in CRAR, RoA, and RoE. Despite geopolitical uncertainties, India's stock markets have remained stable, reflecting the industry's ongoing efforts to enhance financial inclusion and reduce intermediation costs, contributing to a resilient post-Covid recovery. Looking ahead, the financial sector is poised for growth, with ambitions for a prosperous and robust financial services landscape by 2047, emphasizing universal access, efficient capital markets, and support for micro, small, and medium enterprises (MSMEs). As India transitions towards becoming a 'fintech nation' with a focus on innovations like AI and decentralized finance, it must prioritize customer-centric approaches, improve regulatory frameworks, and adapt to the evolving role of capital markets while being prepared for associated challenges.

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