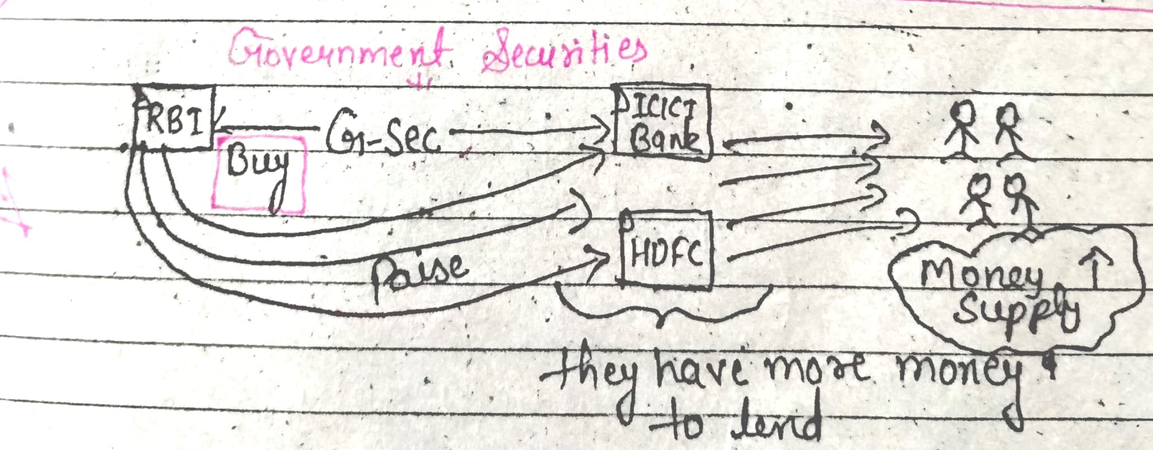
Unit-3 Monetary Policy

- Policy of RBI
  - Monetary policy framework
    - Objectives
    - Transmission mechanism
    - Operating Procedure
  - Organisational Structure

Monetary Policy :- RBI conducts monetary policy by adjusting the supply of money, usually through buying or selling securities in the open market.

Open market operations affect short term interest rates, which in turn affects long term interest rates and economic activity.

When RBI lowers the interest rate, monetary policy is easing (expansionary monetary policy)
When RBI increases the interest rate, monetary policy is tightening (Contractionary monetary policy)



→ When this happens, bank will reduce interest rates to make borrowing more attractive

Monetary Policy Framework

(A) Objectives of Monetary policy

→ The RBI Act, 1934, in its preamble sets out the objectives of the bank as "to regulate the issue of bank notes and keeping the reserves with a view to securing monetary stability in India and generally to operate the currency & credit system of the country to its advantage"

Fundamentally, the primary objective of monetary policy has been the maintainence of judicious balance between price stability and economic growth.

(B) Transmission of Monetary Policy

The transmission can be presented as :-

Stage 1:

Change to monetary policy

↓ Affects

Interest rates

Stage 2:

Interest rates

↓ Affects

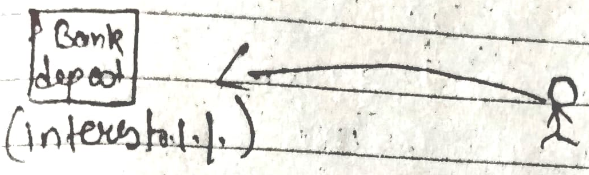
Economic activity & inflation

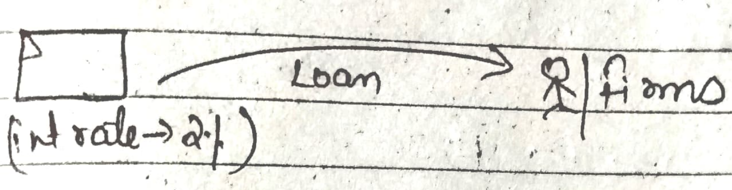
Channels of Monetary policy transmission

(i) Saving & Investment Channel

→ Lower interest rates on bank deposits reduce the incentive of households to save.

→ Lower interest rates for loans can encourage the households & business to borrow more

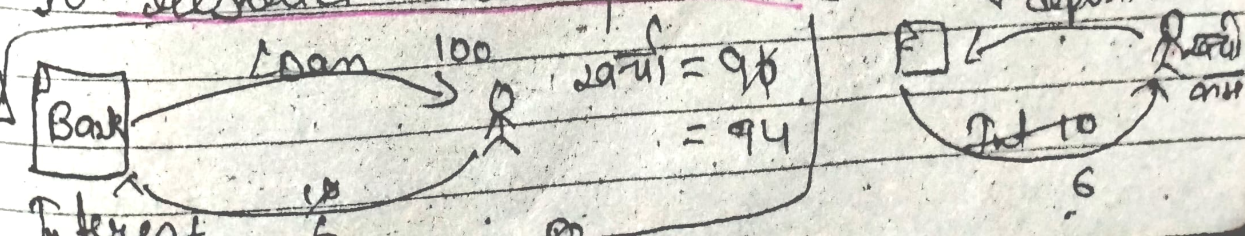




(ii) Cash flow Channel

→ Reduction in lending rates reduces interest repayments on debt, increasing the amount of cash available for households / firms to spend on goods & services.

→ At the same time, a reduction in interest rates reduces the income that households / firms get from deposit and some may choose to restrict their spendings

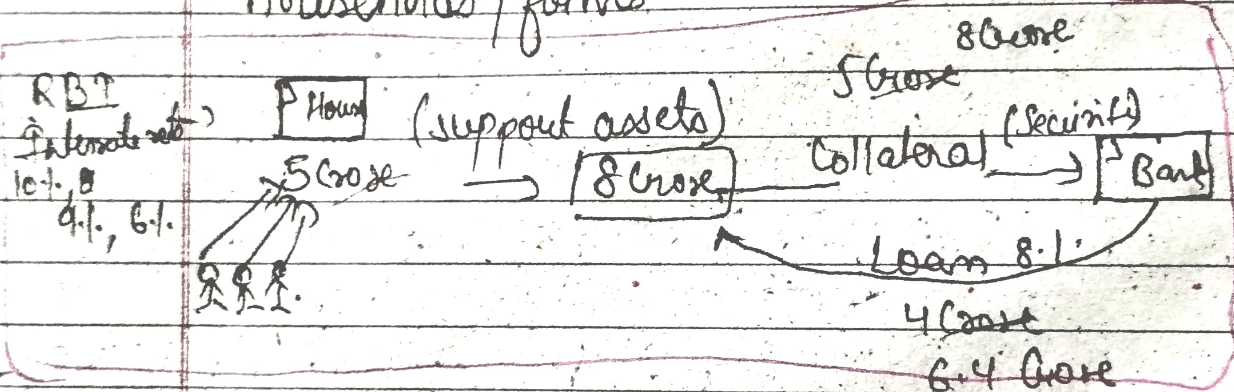


(iii) Asset prices and wealth channel

→ Asset prices & wealth influence how much people can borrow & how much they spend in economy.

→ Lower interest rates support asset prices (e.g housing) by ~~emerging~~ encouraging demand for assets.

→ Higher asset price also increases the collateral of the asset that is available for banks to lend against. Thus can make borrowings much easier for households / firms.



(iv) Exchange rate channel

→ Lower interest rates reduces the returns investors earn from assets in India. Lower returns reduce demand for assets in India, thus foreign investors shift their funds from India.

→ Reduction in interest rates result in lower exchange rate, making foreign

Currency depreciation

goods costlier and domestic goods cheaper. This leads to increase in exports and decrease in imports (Due to increase in exports, inflation may also increase)

Invest (India) 10%

China (12%)

e.g. 1$ = ₹80
1$ = ₹100

Weak [currency depreciation]

foreigners ← export ↑ India (Weak) → demand ↑ Prices ↑ (inflation)

Import ↓

(c) Operating Procedures & Instruments

(i) Quantitative tools – Tools applied by the policy that impact money supply in the entire economy

(ii) Qualitative tools – Specific tools or selective tools that affect money supply in specific sector.

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Tools :- (ii)

(a) Reserve Ratio

→ CRR : Cash reserve ratio refers to the fraction of total net demand and time liabilities (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with RBI

→ SLR : Statutory liquidity ratio is what the scheduled commercial banks in India are required to maintain as fixed % of their net demand & time liabilities (NDTL) in cash, gold or approval securities

(b) Open Market Operation

(c) Moral Suasion :- By way of persuasion the RBI convinces banks to keep money in government securities rather than in certain sectors

Qualitative

(d) Margin requirement :- RBI prescribed certain margins (difference between security & loan amount) agains collateral, which affects borrowing of the customers.

Qualitative

Market Stabilisation Schemes (MSS) :-
it includes policy rates like
Bank rate

The interest rate at which RBI lends long term funds to commercial banks.

RBI $\xrightarrow{\text{Long term loan}}$ HDFC
Interest
(Bank rate)

However, presently RBI also uses Liquidity Adjustment Facility (LAF)

Instrument to adjust liquidity

Repo rate
RBI $\xrightarrow{\text{short term loan}}$ HDFC
Interest

Reverse Repo Rate
RBI ← deposit — ICICI
Interest →
Repo Rate (−) 1%

Marginal Standing facility (MSF) Rate
RBI $\xrightarrow{\text{1 day loan}}$ ICICI
(liquidity crunch)
Interest
MSF rate
Repo Rate (+) 1%

Under this repurchase agreement, banks are required to provide government securities as collateral and later buy them back after predefined time

RBI $\xrightarrow{\text{₹100 loan}}$ ICICI
Collateral
(G-Sec)
3 Mon

* Rate ↑ [Bank rate, Reverse Repo rate, Repo rate, CRR, SLR] — Money Supply ↓

Contractionary monetary policy

③ Organisational Structure

→ The RBI Act, 1934 was amended on (June 27, 2016) for giving a statutory backing the monetary policy framework Agreement (MPFA) and for setting up Monetary Policy committee (MPC). The monetary policy framework agreement is an agreement reached between GOI & RBI on maximum tolerable inflation rate that RBI should target to achieve price stability.

Announcement of an official target range for inflation is known as inflation targeting.

Urjit Patel

Report 2014 → RBI abandon the multiple indicator approach & make inflation targeting the primary objective of its monetary policy.

→ The central govt has notified 4% consumer price index (CPI) inflation as target

FAILURE

- Average inflation > upper tolerance level (for 3 consecutive quarters)
- Average inflation < Lower tolerance level (for 3 consecutive quarters)

- RBI is mandated to publish a monetary policy report every 6 months