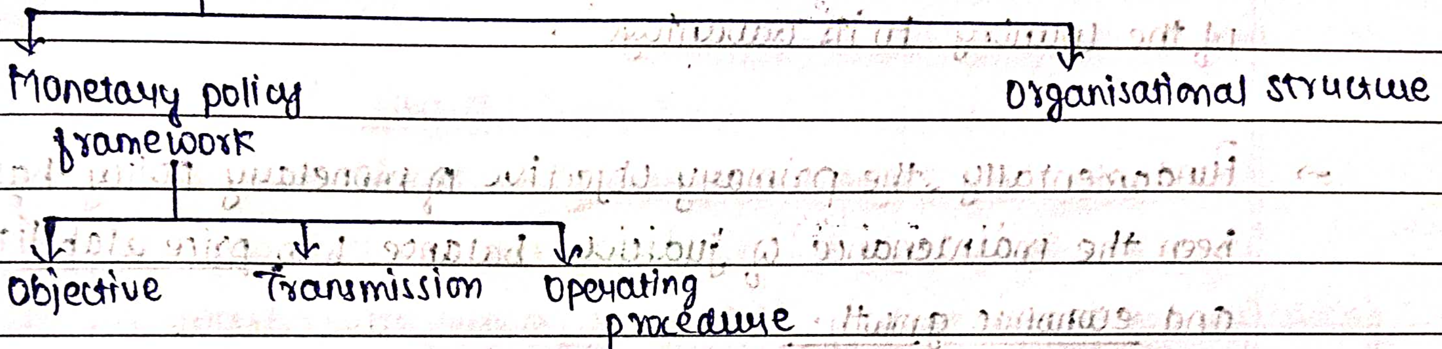
Unit III - Monetary Policy

- Policy of RBI



* **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).

* 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 of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".

→ Fundamentally, the primary objective of monetary policy has been the maintenance of judicious balance b/w price stability and economic growth.

(B) Transmission of monetary policy

→ The transmission can be presented as:-

Flow	Stage
Change to monetary policy	
↓ AFFECTS	Stage 1
Interest Rates	
↓ AFFECTS	Stage 2
Economic Activity & Inflation	

→ Channels of Monetary Policy Transmission :-

(i) Saving and Investment Channel

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

→ Lower interest rates on loan can encourage households and business to borrow more.

(ii) Cash Flow Channel

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

-> At the same time, reduction in Interest rates reduces the income that households/firms get from deposits & some may choose to restrict their spendings.

(iii) Asset Prices and Wealth Channel

-> Asset price and Wealth influence how much people can borrow and how much they spend in economy.

-> Lower interest rate support asset prices (eg. Housing) by encouraging demand for assets.

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

(iv) Exchange Rate Channel

-> Lower interest rates reduce the returns investor earns 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 (currency depreciation), making foreign goods costlier and domestic goods cheaper. This leads to increase in Exports and decrease in Imports.
(Due to increase in Export, Inflation may also increase)

(C) Operating Procedures and 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.

- Tools :-

(a) Reserve Ratio: [Quantitative]

→ CRR – Cash Reserve ratio refers to 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 percentage of their demand and time liabilities (NDTL) in Cash, Gold or approved securities.

[QUANTITATIVE]

(b) Open Market Operations – buying and selling of G-Sec by RBI.

[QUALITATIVE]

(c) Moral Suasion – By way of persuasion, the RBI convinces banks to keep money in G-Sec, rather than in certain sectors.

[QUALITATIVE]

(d) Margin requirement – RBI prescribes certain margin (difference b/w security and loan amount) against collateral, which affects borrowings of the customers.

• Market Stabilisation Schemes (MSS) [QUALITATIVE]

→ It includes policy rates like Bank rates

(Interest rate at which RBI lends long term funds to commercial Banks)

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

LAF → Instruments to adjust liquidity:

- Repo Rate
- Reverse Repo Rate
- Marginal Standing Facility (MSF) rate

• Repo Rate - Under this Repurchase agreement, Banks are required to provide G-Sec as collateral and later buy them back after predefined time.

• MSF Rate - When commercial banks have liquidity crunch and need instant money for (1-3 days) very short period, then RBI charges MSF Rate which is Repo Rate (+) 1%.

• Reverse Repo Rate - Commercial Banks make deposit with RBI and RBI pays interest on it, called Reverse Repo Rate, which is usually Repo Rate (-) 1%.

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* Rate ↑, Money Supply ↓ (contractionary monetary policy)

* Organisational Structure

→ The RBI Act, 1934 was amended on June 27, 2016 for giving a statutory backing to the monetary policy framework agreement (MPFA) and for setting up Monetary Policy Committe (MPC) [6 members]

- The Monetary Policy Framework Agreement is an agreement reached b/w GOI and 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 → January, 2014 Report ⇒ RBI abandon the multiple indicator approach and make Inflation Targeting the primary objective of its Monetary policy.

→ The Central Government has notified 4% Consumer Price Index [CPI] inflation as target. [5 Aug. 2016 – March 31, 2021]

→ FAILURE
- → Average Inflation > Upper Tolerance level [6%]
  - for three consecutive quarters
- → Average Inflation < Lower Tolerance level [2%].
  - for three consequtive quarters

→ RBI is mandated to publish a monetary policy report every six months.