UNIT - 3: MONETARY POLICY

Monetary Policy defined

- Reserve Bank of India uses monetary policy to manage economic fluctuations and achieve price stability.
- Reserve Bank of India 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 influence longer-term rates and economic activity.
- When central banks lower interest rates, monetary policy is easing. When it raises interest rates, monetary policy is tightening.

- Expansionary MP

Deflationary MP | contractionary

THE MONETARY POLICY FRAMEWORK

The central bank, in its execution of monetary policy, functions within an articulated monetary policy framework which has three basic components, viz.

(i) the objectives of monetary policy,

(ii) the analytics of monetary policy which focus on the transmission mechanisms, and

(iii) The operating procedure which focuses on the operating targets and instruments.

The Objectives of Monetary Policy

■ The monetary policy of a country is in fact a reflection of its economic policy and therefore, the objectives of monetary policy generally coincide with the overall objectives of economic policy.

■ The Reserve Bank of India Act, 1934, in its preamble sets out the objectives of the Bank as 'to regulate the issue of bank notes and the 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 a judicious balance between price stability and economic growth.

Moderate Inflation

Given the development needs of developing countries, the monetary policy of such countries also incorporates explicit objectives such as:

(i) maintenance the economic growth,

Agriculture, Industrial

(ii) ensuring an adequate flow of credit to the productive sectors,

(iii) sustaining - a moderate structure of interest rates to encourage investments, and

(iv) creation of an efficient market for government securities.

Considerations of financial and exchange rate stability have assumed greater importance in India recently on account of the increasing openness of the economy and the progressive economic and financial sector reforms.

Transmission of Monetary Policy

The transmission of the monetary policy describes how changes made by the Reserve Bank to its monetary policy settings flow through to economic activity and inflation. This process is complex and there is a large degree of uncertainty about the timing and size of the impact on the economy. In simple terms, the transmission can be summarised in two stages.

1. Changes to monetary policy affect interest rates in the economy.
2. Changes to interest rates affect economic activity and inflation.

Although we know that monetary policy does influence output and inflation, we are not certain about how exactly it does so, because the effects of such policy are visible often after a time lag which is not completely predictable.

CHANNELS OF MONETARY POLICY TRANSMISSION

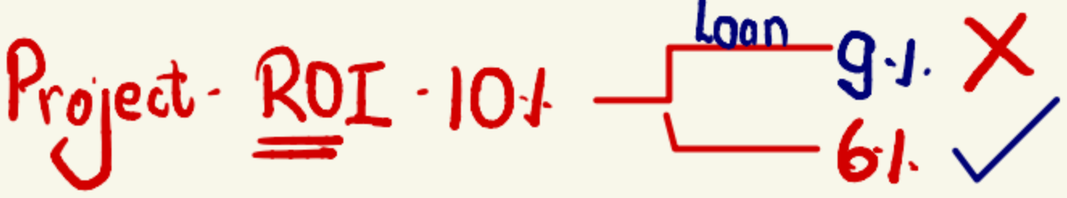
1) Saving and Investment Channel

Monetary policy influences economic activity by changing the incentives for saving and investment. This channel typically affects consumption, housing investment, and business investment.

1↓

- Lower interest rates on bank deposits reduce the incentives of households to save their money. Instead, there is an increased incentive for households to spend their money on goods and services.

⬇️ Lower Interest Rates 👉 ⬇️ Savings & ⬆️ Expenditure in Economy



■ Lower interest rates for loans can encourage households to borrow more as they face lower repayments. Because of this, lower lending rates support higher demand for assets, such as housing.

⬇️ Low Interest rates 👉 ⬆️ Borrowings 👉 ⬆️ Higher Demand for Asset

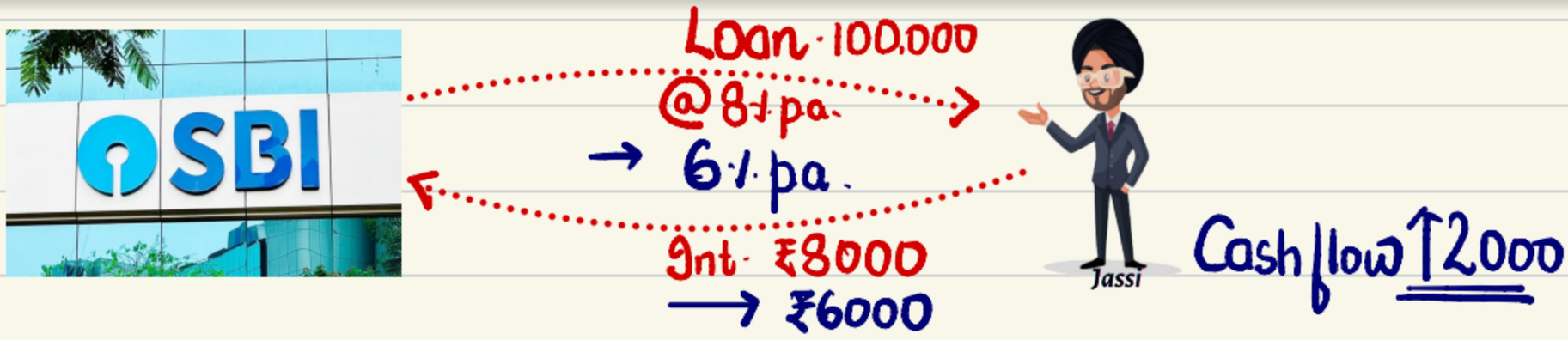
■ Lower lending rates can increase investment spending by businesses (on capital goods like new equipment or buildings). This is because the cost of borrowing is lower, and because of increased demand for the goods and services they supply.
This means that returns on these projects are now more likely to be higher than the cost of borrowing, helping to justify going ahead with the projects. This will have a more direct effect on businesses that borrow to fund their projects with debt rather than those that use the business owners' funds.

⬇️ Low Interest Rates 👉 ⬆️ More Investment by Business because cost of borrowing is low & Demand is high.

2) Cash-flow Channel

■ Monetary policy influences interest rates, which affects the decisions of households and businesses by changing the amount of cash they have available to spend on goods and services.

■ A reduction in lending rates reduces interest repayments on debt, increasing the amount of cash available for households and businesses to spend on goods and services. *For example*, a reduction in interest rates lowers repayments for households with variable-rate mortgages, leaving them with more disposable income.



■ At the same time, a reduction in interest rates reduces the amount of income that households and businesses get from deposits, and some may choose to restrict their spending.

FD - 100,000
@ 6%
→ 4%

Interest - ₹6000
- ₹4000

Cash flow ↓ 2000

These two effects work in opposite directions, but a reduction in interest rates can be expected to increase spending in the Indian economy through this channel (with the first effect larger than the second)

3) Asset Prices and Wealth Channel

■ Asset prices and people's wealth influence how much they can borrow and how much they spend in the economy. The asset prices and wealth channel typically affects consumption and investment.

■ Lower interest rates support asset prices (such as housing and equities) by encouraging demand for assets. One reason for this is that the present discounted value of future income is higher when interest rates are lower.

■ Higher asset prices also increase the equity (collateral) of an asset that is available for banks to lend against. This can make it easier for households and businesses to borrow.

Mortgage

■ An increase in asset prices increases people's wealth. This can lead to higher consumption and housing investment as households generally spend some share of any increase in their wealth.

Int rate ↓

Loan ↑

Demand for Assets ↑
Price ↑

PV

Value of Assets
[Depends on future economic benefit]

90,909 — 10% → F.V. 100,000

92,593 — 8%

Int Rate ↓
Assets PV ↑

4) Exchange Rate Channel

The exchange rate can have an important influence on economic activity and inflation. It is typically more important for sectors that are export-oriented or exposed to competition from imported goods and services.

Repo Rate

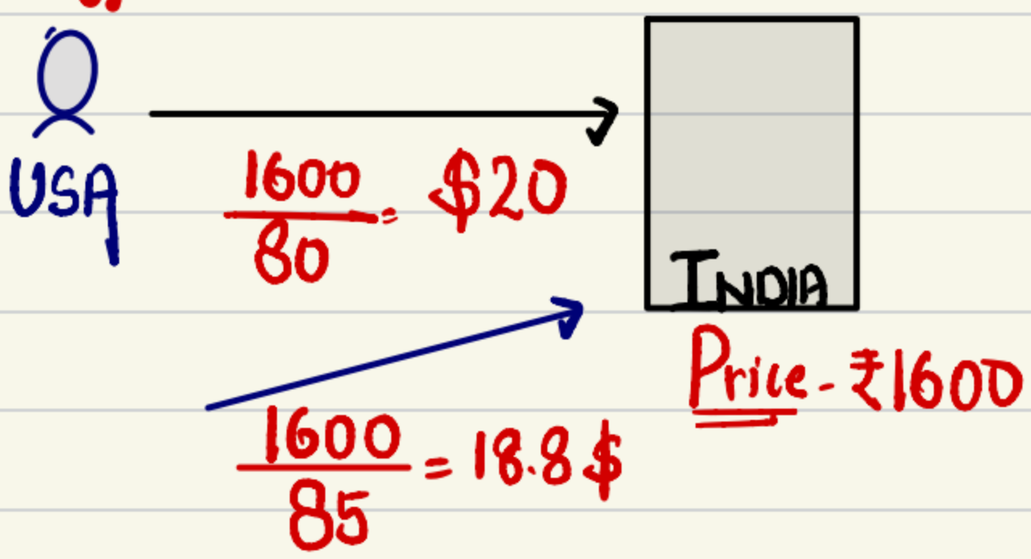
- If the Reserve Bank lowers the cash rate it means that interest rates in India have fallen compared with interest rates in the rest of the world (all else being equal).
- 👉Lower interest rates reduce the returns investors earn from assets in India (relative to other countries). Lower returns reduce demand for assets in India (as well as for Indian rupees) with investors shifting their funds to foreign assets (and currencies) instead.
- A reduction in interest rates (compared with the rest of the world) results in a lower exchange rate, making foreign goods and services more expensive compared with those produced in India. This leads to an increase in exports and domestic activity. A lower exchange rate also adds to inflation because imports become more expensive in Indian rupees.

Int Rates ↓ ⇢ Currency Depreciate

1$ = ₹80

1$ = ₹85

1.

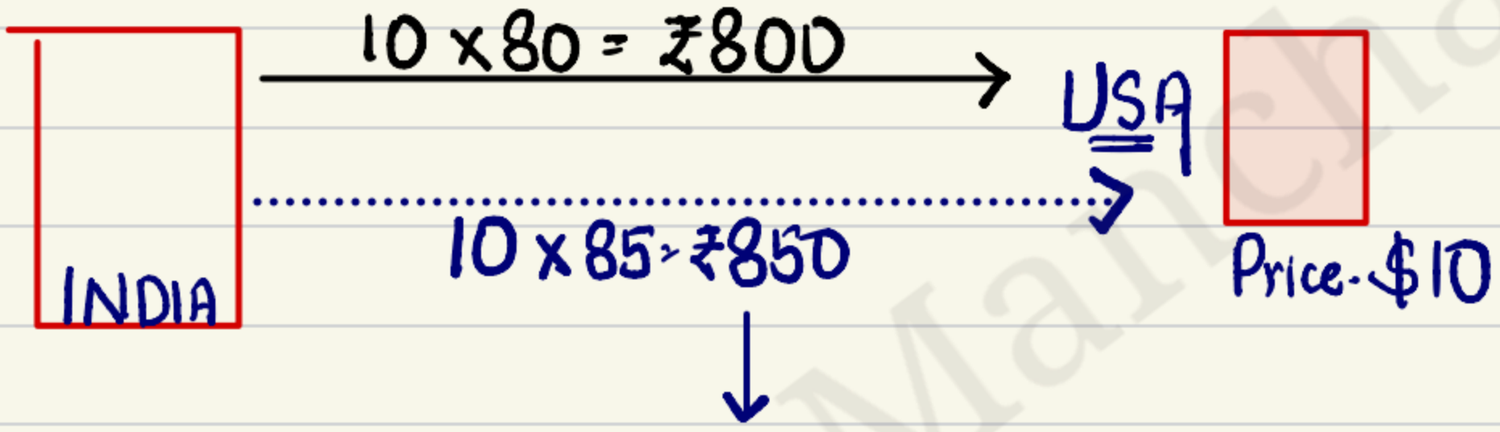


↓

Exports ↑

Imports ↓

2.



↓

Cost ↑

Price ↑

↳ Inflation

Operating Procedures and Instruments

Quantitative tools

The tools applied by the policy that impact money supply in the entire economy, including sectors such as manufacturing, agriculture, automobile, housing, etc.

1) Reserve Ratio

- **Cash Reserve Ratio (CRR)** – Banks are required to set aside this portion in cash with the RBI. The bank can neither lend it to anyone nor can it earn any interest rate or profit on CRR.

- **Statutory Liquidity Ratio (SLR)** – Banks are required to set aside this portion in liquid assets such as gold or RBI approved securities such as government securities. Banks are allowed to earn interest on these securities, however it is very low.

2) Open Market Operations (OMO)

- In order to control money supply, the RBI buys and sells government securities in the open market. These operations conducted by the Central Bank in the open market are referred to as Open Market Operations.

- When the RBI sells government securities, the liquidity is sucked from the market, and the exact opposite happens when RBI buys securities. The former is done to control inflation. The objective of OMOs are to keep a check on temporary liquidity mismatches in the market, owing to foreign capital flow.

1. CRR.

No Interest

CRR- 10% of Total Deposits
= 10 Cr.

Total Deposit - ₹100 Cr.

Money available for lending- ₹90 Cr.

2. SLR

Total deposit - ₹100 cr.

SLR - 5% = 5cr.

Cash | Gold | Govt Sec

Int

Reserve Ratios ↑ ⟶ Money Supply ↓

Res. Ratios ↓ ⟶ Money Supply ↑

→ OMO

Obj	OMO
Money Supply ↓	Sell Govt Sec. to Bank
Money Supply ↑	Buy Govt Sec. from Bank.

Qualitative tools

Unlike quantitative tools which have a direct effect on the entire economy's money supply, qualitative tools are selective tools that have an effect in the money supply of a specific sector of the economy.

1) Margin requirements

The RBI prescribes a certain margin against collateral, which in turn impacts the borrowing habit of customers. When the margin requirements are raised by the RBI, customers will be able to borrow less.

2) Moral suasion

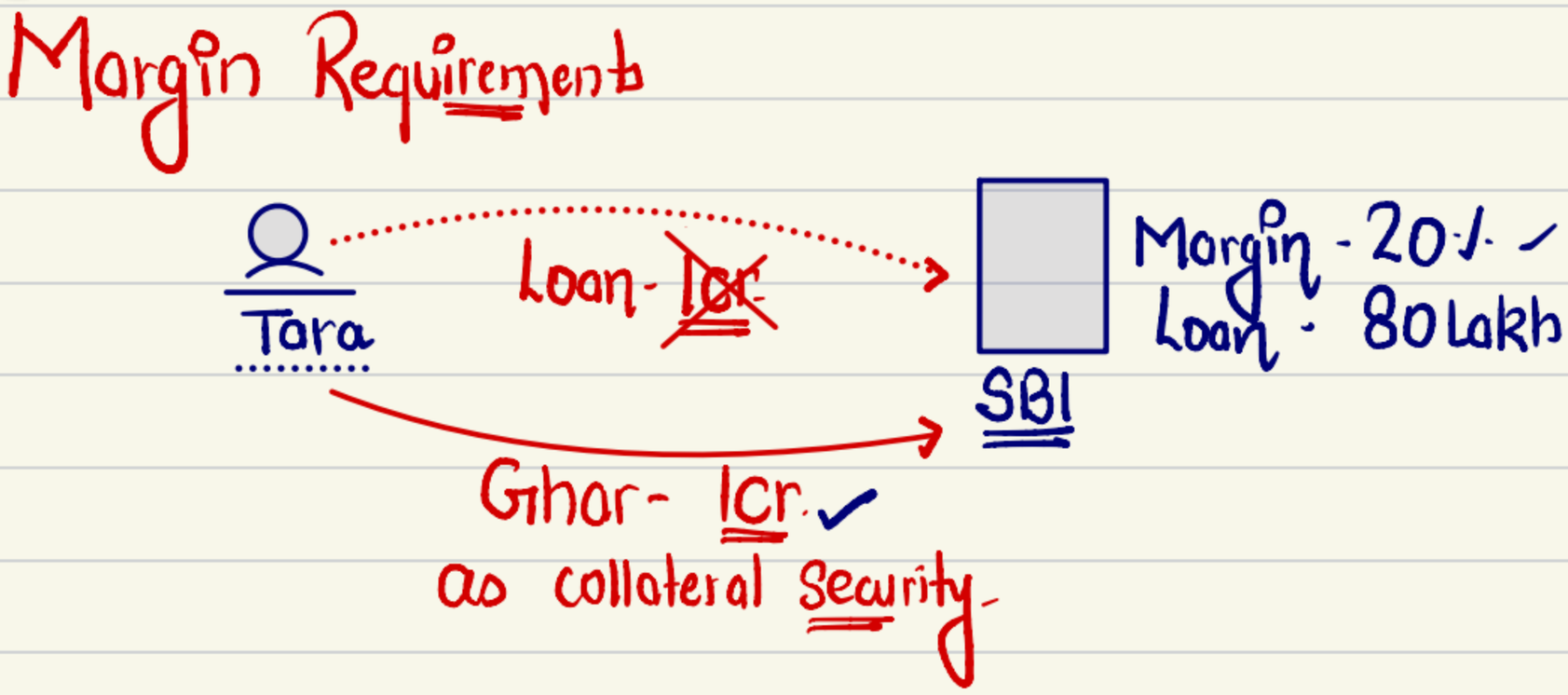
By way of persuasion, the RBI convinces banks to keep money in government securities, rather than certain sectors.

3) Selective credit control

Controlling credit by not lending to selective industries or speculative businesses.

Market Stabilisation Scheme (MSS)

It is primarily aimed at absorbing excess liquidity from the market, particularly when there is an influx of foreign capital or other factors leading to surplus liquidity, through sale of short-dated government securities and treasury bills Z



Policy Rates

Bank rate

- The interest rate at which RBI lends long term funds to banks is referred to as the bank rate. However, presently RBI does not entirely control money supply via the bank rate.
- It uses Liquidity Adjustment Facility (LAF) – repo rate as one of the significant tools to establish control over money supply.
- Bank rate is used to prescribe penalty to the bank if it does not maintain the prescribed SLR or CRR.

Liquidity Adjustment Facility (LAF)

RBI uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are:

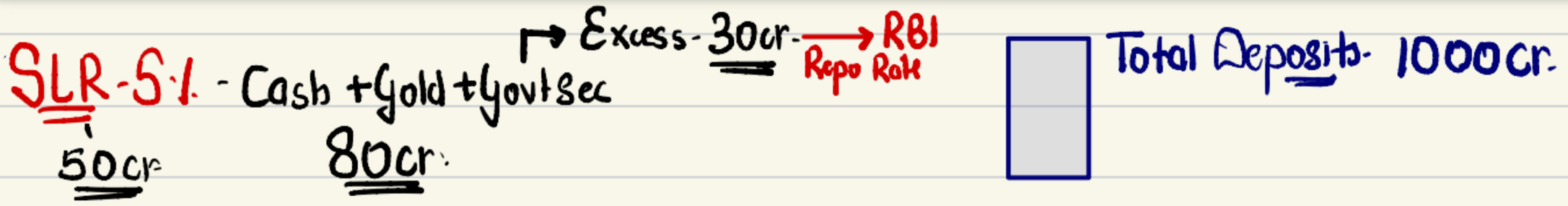
📝**Repo rate**: Repo rate is the rate at which banks borrow from RBI on a short-term basis against a repurchase agreement. Under this policy, banks are required to provide government securities as collateral and later buy them back after a pre-defined time.

📝**Reverse Repo rate**: It is the reverse of repo rate, i.e., this is the rate RBI pays to banks in order to keep additional funds in RBI. It is linked to repo rate in the following way:

Reverse Repo Rate = Repo Rate – 1

📝**Marginal Standing Facility (MSF) Rate**: MSF Rate is the penal rate at which the Central Bank lends money to banks, over the rate available under the repo policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities.

MSF Rate = Repo Rate + 1MSF Rate = Repo Rate + 1



1. Bank Rate

Loan

Long term

Bank Rate

2. Repo Rate

Re-purchase option

Short-term Loan

Int - Repo Rate

Govt sec. as collateral

₹100

Money Supply ↓ - Repo Rate ↑

3. Reverse Repo Rate

Deposit / Loan

Int - Rev Repo

Govt Sec.

Repo Rate > Reverse Repo Rate

THE ORGANISATIONAL STRUCTURE FOR MONETARY POLICY DECISIONS

An understanding of the organisational structure for monetary policy decisions is necessary to understand the way monetary policy is conducted in India.

- The Reserve Bank of India (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 a Monetary Policy Committee (MPC).
- The Monetary Policy Framework Agreement is an agreement reached between the Government of India and the Reserve Bank of India (RBI) on the maximum tolerable inflation rate that the RBI should target to achieve price stability.

- Announcement of an official target range for inflation is known as inflation targeting.
- The Expert Committee under Urijit Patel to revise the monetary policy framework, in its report in January, 2014 suggested that RBI abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy. The inflation target is to be set by the Government of India, in consultation with the Reserve Bank, once in every five years.

- Accordingly,The Central Government has notified 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.

- The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.

■ The following factors are notified by the central government as constituting a failure to achieve the inflation target:

6%

(a) The average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or

(b) The average inflation is less than the lower tolerance level for any three consecutive quarters

2%

The choice of CPI was made because it closely reflects cost of living and has larger influence on inflation expectations compared to other anchors.

Chapter over :)