CHAPTER – 8 : Money Market

UNIT-3 : Monetary Policy

- RBI manages economic fluctuations like inflation to maintain price stability through adjustments in money supply (monetary policy)
- open market operations are done through buying and selling security in open market
- OMO (open market operations) impact short term interest rates, influencing long term interest rates

Lowering rates eases monetary policy raising rates tightens monetary policy

Monetary Policy - Framework

Basic components		
Objectives of Monetary policy	Analytics of Monetary Policy	Operating procedures

1. Objectives

- RBI act 1934:
  - Regulating issue of notes and keeping reserves for monetary stability
  - operating currency and credit system

Primary objectives (developing countries)

- Maintenance of economic growth
- adequate flow of credit to productive sectors
- sustaining a moderate structure of interest rate to encourage investments
- creation of effective market for govt. securities

- The primary objective is to maintain a balance between price stability and economic growth.

2. Analysis / Transmission

- The Reserve Bank's monetary policy changes impact economic activity and inflation through transmission.
- Stages of transmission
  - changes to monetary policy affecting interest rate
  - changes to interest rates affecting economic activity and inflation

Channels of Transmission

(a) Savings and investment channel

Interest	Lower interest rates encourage spending over savings
Loans	Reduced loan rates stimulate borrowing and increase demand for assets
Investment	Lower borrowing costs promote business investment in capital goods, boosting product demand

(b) Cash flow channel

Impact	Monetary policy affects interest rates, influencing spending decisions
Lending	Lower rates decrease interest payments, freeing cash for spending
Income	Lower rates reduce income from deposits, restricting spending
Economy	Lower rates spending in economy

(c) Asset price and wealth channel

Channel	Impacts consumption and investment, affecting borrowing and spending
Interest	Lower rates support asset prices and elevate future income
Equity	Higher asset prices increase equity, easing borrowing
Wealth	wealth boost utilization and investment

(d) Exchange rate channel

RBI	Lowers cash rate when India's interest rates are below global rates
Investment	Lower returns on Indian assets demand
Inflation	Lower rates make foreign goods costlier, potentially causing inflation

3. Operating Procedure and Instruments

(a) Quantitative Tools

Reserve Ratio	RBI sets a percentage of cash reserve that banks have to keep aside. Types: Reserve Ratio • Cash Reserve Ratio (CRR) - portion of cash set aside by RBI. Cannot lend nor earn interest on CRR • Statutory Liquidity Ratio (SLR) - portion of liquid assets (gold or RBI securities). Set aside by bankers as per RBI can earn interest but its low
Open Market Operations (OMO	RBI controls money supply through buying and selling govt, securities in open market • RBI sells reduces liquidity in market • RBI buys increases liquidity in market

(b) Qualitative Tools

Margin Requirement	• Difference between value of collateral and amount of loan
Moral Suasion	• RBI convinces banks to invest in govt. securities through persuasion
Selective credit control	• Controlling credit by not lending to certain industries

(c) Market Stabilization Scheme (MSS)

Policy Rates	• Bank Rates: Interest rate at which RBI lend long term loan to banks • But, RBI presently uses liquidity adjustment facilities (LAF) - Repo rate • RBI has set penalties for defaulter bank in non-maintenance of CRR and SLR
Liquidity Adjustment Facilities (LAF)	• Repo rate: Banks borrows form RBI, • short term against repurchase agreement • Reverse Repo Rates : RBI pays to banks to keep additional funds in RBI • Reverse Repo Rates = repo rate -1
Marginal Standing Facilities Rates	• MSF is panel rate at which Central Bank lends money to banks over rate available under Rep policy MSF rate = Repo rate + 1