
MONETARY
POLICY

Introduction to Monetary Policy

Definition*:* Monetary policy is the macroeconomic policy laid down by the central bank. It involves **management of money supply and interest rate** and is the demand side economic policy used by the government of a country to achieve macroeconomic **objectives like inflation, consumption, growth and liquidity**.

In India, monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth.

OBJECTIVES OF MONETARY POLICY

a) MONETARY POLICY AND ECONOMIC GROWTH:

1- Economic growth refers to increase in national income. To induce growth capital formation should be high.

2- Monetary policy promotes capital formation by mobilising resources and making available to investors at the right time and at a reasonable rate of interest.

3- The Central banks adopt **a flexible policy promote** capital formation and economic growth.During inflation it adopts **a dear money policy to control the supply of credit and during depression it adopts a cheap monetary policy**

b) Monetary Policy and Price stability:

1- Monetary policy aims at controlling fluctuations in the **price level** as instability the price level produces adverse effects on the economy .

2- Various measures are used by the central bank to control inflation or deflation. While a mild inflation is better for the economy, a running or galloping inflation is harmful for the economy. Similarly,it is necessary to control deflation by taking prompt action.Otherwise it will result in depression.

3- While ensuring **price stability** ,the government and the central bank should ensure that the growth is not affected and business cycles are actually controlled.When price stability is given importance, the government may have to compromise on the objective of full employment as price stability and full employment are not compatible with each other.

c) Monetary Policy and Full Employment : Full employment refers to a situation where the productive resources of the economy are fully employee.It also implies the absence of involuntary unemployment .It however,does not mean **100% employment**. When there is full employment in the economy, a higher level of income, output and improvement in standard of living become possible. This objective is given importance by many advanced countries in recent times.

d) Monetary Policy and Exchange Rate Stability: Till 1970s,exchange rate stability was emphasised by monetary policy . Under the gold standard it was given much importance. It was considered necessary to promote international trade and control movement of capital between nations.

2- Some economists are of the opinion that exchange rate stability can be attained only by sacrificing internal price stability. At present this objective is considered secondary and many governments prefer a flexible exchange rate policy so that adjustments can be made as per the requirements of the economy .

Instruments Of Monetary Policy- QUANTITATIVE

BANK RATE

INCREASE – SUPPLY CONTRACTED

OPEN MARKET OPERATIONS

CRR INCREASE CONTRACT SUPPLY

SLR DECREASE –EXPANSIONARY POLICY

REPO

REVERSE REPO

QUALTITATIVE

- MINIMUM MARGIN
- CEILING ON CREDIT
- MORAL SUASION
- DIFFERENTIAL INTEREST RATE
- DIRECT ACTION

Quantitative measures

The quantitative credit control is also called as the general credit control. The main weapons used under this method are:

- ❖ **Bank rate :-** It is the rate at which the Central bank discounts the securities of commercial banks.it is also called as the **discount rate .**
- Bank rate influences the cost of credit . Changes in the discount rate bring about changes in the short term and long term interest rates and thereby the level of economic activity.
- Capital movement between countries is also influenced by the changes in the bank rate.Thus it influences both availability and cost of credit.
- During inflation the central bank increases the bank rate .due to this credit rate from the central bank becomes costlier. Commercial banks are discouraged from borrowing from the central bank
- When the bank rate is increased, other lending rates will also rise making credit costlier. Hence investments will decline leading to fall in employment,income and demand for goods and services. This in turn will reduce the price level. Thus a rise in bank rate leads to a reduction in price level and during depression the bank rate is reduced to push up the price level and bring about a revival in the economy
- For the bank rate to succeed, the commercial banks should not excess reserves with them and they should have adequate securities to be discounted with the central bank.

- **Open Market Operations** : An Open market **operation refers to buying and selling of government securities by the Central bank**. During the period of inflation the bank will sell securities and during depression it will purchase securities from the public and financial institutions.
- The central bank uses this weapon to overcome seasonal stringency in funds. During inflation when there is too much money supply in the economy ,the central bank sells securities. These securities are purchased by the commercial banks.
- This reduces their cash reserve which in turn leads to expansion of credit. This in turn will lead to increase in investment, production and employment Demand for goods and services will increase leading to a rise in the price level. Thus, this weapon helps the central bank to control the liquidity in the economy

RESERVE BANK OF INDIA
CRR
SLR

- **Cash reserve ratio:-** Cash Reserve Ratio is one of the many monetary policy tools that RBI uses to control the money supply in the economy. In simple terms, the Cash reserve ratio is a certain percentage of cash that all banks have to keep with the RBI as a deposit. This percentage is fixed by the RBI and is changed from time to time by the central bank itself.

  Suppose if CRR is 3% this means for every Rs 100 worth of the deposits the bank has to keep Rs 3 with the RBI

- **Statutory Liquidity Ratio :-** Statutory liquidity ratio is a monetary policy tool that the Reserve Bank of India (RBI) uses to assess the liquidity at the banks' disposal. SLR requires banks to keep a certain amount of their money invested in specific central and state government securities.

  SLR refers to the percentage of the aggregate deposits that commercial banks have to invest in liquid assets. The RBI has specified such liquid assets which banks have to invest in to maintain their SLR.

As per RBI, liquid assets may be maintained –(i) in cash, or

(ii) in gold valued at a price not exceeding the current market price, or

Approved securities' means those securities that are issued by the Central Government or any State Government or other securities that are specified by the RBI from time to time. The RBI specifies the SLR status of securities issued by the Government of India and the State Governments.

1. Dated securities of the Government of India
2. Treasury Bills of the Government of India
3. Dated securities of the Government of India issued from time to time under the market borrowing programme and the Market Stabilisation Scheme.
4. State Development Loans (SDLs) issued from time to time under their market borrowing programme.
5. Any other instrument as may be notified by the Reserve Bank of India.

While the main objective of monetary policy tools like CRR and SLR is to maintain liquidity, there are multiple objectives that these tools serve as well.

1) One of the main objectives is to prevent commercial banks from liquidating their liquid assets when the RBI raises the CRR.

2) SLR is used by the RBI to control credit flow in the banks.

3) In a way, SLR also makes commercial banks invest in government securities.

4) Making banks invest a portion of their deposits in government securities also ensures the solvency of such banks.

5) SLR might be a monetary policy tool, but it has also helped the government sell a lot of their securities.

So SLR helps in the government’s debt management programme and RBI’s monetary policy as well.

Repo rate :- The term ‘REPO’ denotes repurchase option or agreement. Used as a tool in the money market, it facilitates borrowings through collateral of specified debt instruments in the economy, which can include government bonds, treasury bills and the likes. When lending finances, the central bank charges interest at a specified rate called repo rate.

The importance of repo rate extends to its effects on various aspects of a country’s economy.

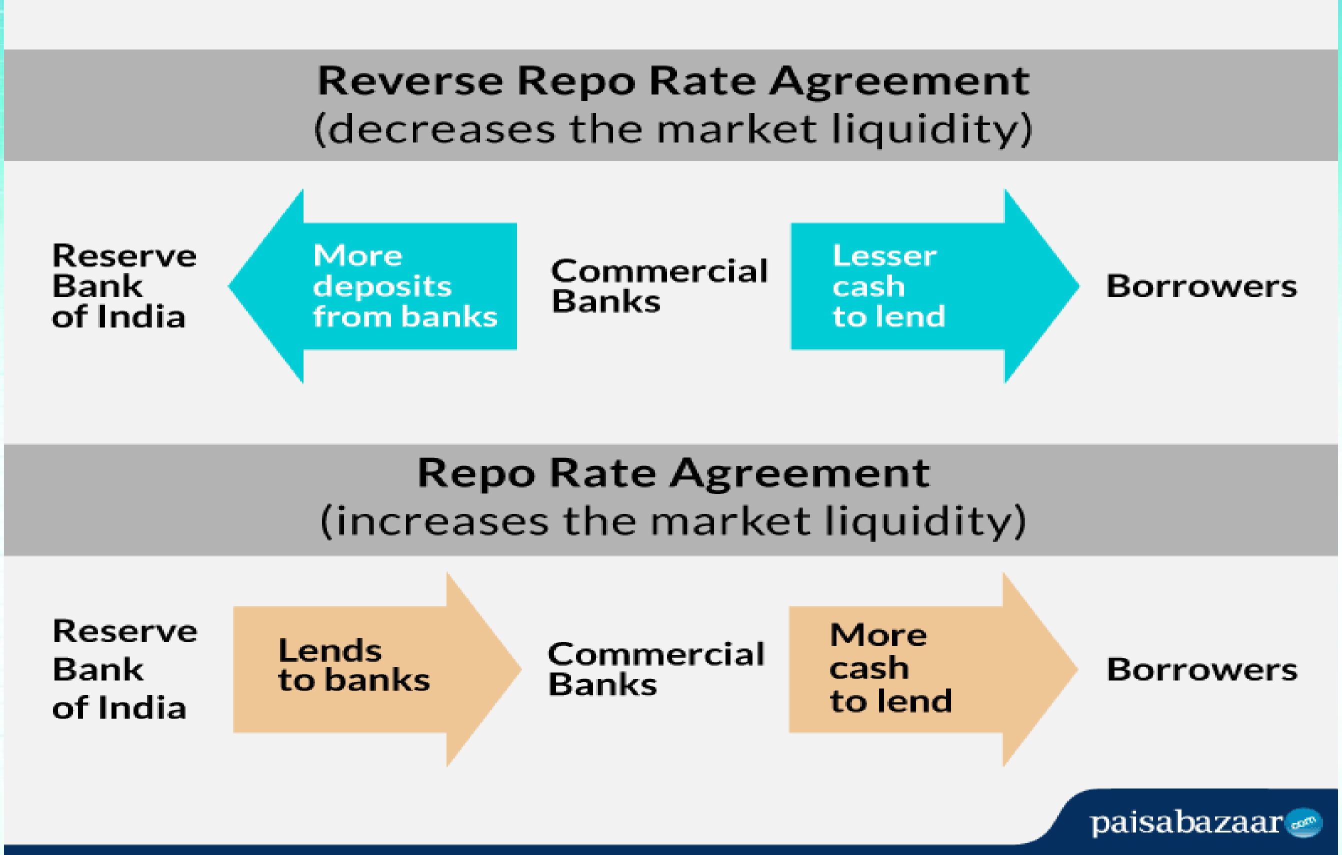
a) The RBI uses it as a control mechanism to infuse or decrease liquidity in the financial system.

b) A change in repo rate affects the cost of funds for commercial banks, thus impacting their policies regarding retail lending.

c) Cuts in repo rates can be immensely useful in controlling inflation and achieving price stability in the financial market.

d) Change in repo rates affects other rates like home loan interest rate, rates on bank deposits, etc.

Reverse repo rate :- Reverse repo as the name suggests is an opposite contract to the Repo Rate. Reverse Repo rate is the rate at which the Reserve Bank of India borrows funds from the commercial banks in the country. In other words, it is the rate at which commercial banks in India park their excess money with Reserve Bank of India usually for a short-term.



Qualitative instruments

The Qualitative Instruments are also known as the Selective Tools of monetary policy. These tools are not directed towards the quality of credit or the use of the credit. They are used for discriminating between different uses of credit. It can be discrimination favoring export over import or essential over non-essential credit supply. This method can have influence over the lender and borrower of the credit. The Selective Tools of credit control comprises of following instruments.

A. Minimum margin requirements :- while lending commercial banks accept securities,deduct a certain margin from the market value of security.this margin is fixed by RBI and adjusted according to the requirements .the margin requirements range between **20 % to 75% .**

   When credit has to be expanded margins are lowered and they are increased when there has to be contraction of credit. In the 1960s RBI followed liberal credit policy for certain commodities like oil seeds,vegetable oil,cotton.

   This instrument is also used by RBI to check speculative hoarding of commodities. In 1965 ,RBI introduced the credit authorisation scheme under which all commercial banks had to obtain the approval of RBI before sanctioning credit of rs.1 crore or more. Ths limit was raised to 6 crores in 1986.it was further liberalised further in 1987 and finally withdrawn in 1988

   In its place RBI introduced the credit monitoring arrangement (CMA) . under this RBI would monitor and scrutinise all loans exceeding rs 2 crores in the case of term loans and rs .5 crores to any single party for working capital requirement

Ceiling on credit : It implies fixing a limit for the different types of loans sanctioned by banks. Through this,lending capacity of banks is influenced by RBI

Moral suasion: RBI uses persuasion to influence lending activities of banks. It sends letters to banks periodically advising them to follow sound principles of banks. Discussions are held by RBI with banks to control the flow of credit to the desired sectors

Differential rate of interest : under this RBI fixes different rates of interest for different sectors . For eg. the priority sector is always sanctioned loans at subsidiary rate. RBI gives clear instruction regarding amount of loan to be sanctioned , the rate of interest to be charged .

Direct action :- it is an extreme step taken by RBI . it involves refusal by RBI to extend credit facilities ,denial of permission to open new branches . RBI may also give wide publicity about the erring banks to create awareness

During inflation the central bank takes the following steps

1. **Increase the bank rate,repo and reverse repo rates.**
2. **Sells securities**
3. **Increases the cash reserve ratio**
4. **Rises the margin requirements**
5. **Controls credit for unproductive and speculative purposes**

Monetary Policy In India - Goals,Targets and Instruments

Goals :- Goals are framed by the RBI taking into consideration the various requirements of the economy . the main goals of the monetary policy in india are price stability and economic growth.

1. Price Stability: Price Stability implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favourable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability.

2. Economic growth : Monetary policy influences economic growth through money supply, rate of interest and exchange rate .if money supply is expanded to accelerate growth may lead to inflation . if inflation is controlled through a tight monetary policy, economic growth will slow down . Exchange rate fluctuations also affect economic growth . if there is too much money supply it will reduce the external value of the currency. A balancing rate has to be done by the central bank in such a way that consensus is obtained to achieve the objectives

Instruments

- Instruments refers to the quantitative and qualitative credit control instruments.
- While quantitative instruments control the quantity of credit , qualitative instruments regulate the quality or direction of credit.
- The main quantitative instruments are bank rate,open market operation,cash reserve ratio and statutory liquidity ratio.
- The qualitative weapons are variation in margin requirements ,credit rationing,moral suasion.
- The central bank uses both quantitative and qualitative measures to achieve the various objectives of monetary policy

TARGETS

- Targets for monetary policy refers to specific value for certain economic variables.
- The targets of monetary policy in india are related to money supply, rate of interest and exchange rate . money supply is regulated by the central bank to avoid higher inflation as well as recession.
- The interest rate stability is an essential factor for economic growth .if the rate of interest is high ,savings will increase but investment will be affected and vice versa.
- The monetary policy has to be framed in such a way that a stable interest rate prevails . the RBI continuously monitors the situation adjusts the interest rate to maintain liquidity in the market and ensure stability
- The RBI has to maintain a stable exchange rate to accelerate growth as well as to maintain price stability

Inflation Targeting

- Inflation targeting is a monetary policy where the central bank sets a specific inflation rate as its goal. The central bank does this to make you believe prices will continue rising. It spurs the economy by making you buy things now before they cost more.
- The central bank estimates the expected rate of inflation makes it public as the target rate the actual rate of inflation is different from the target rate,this measures are taken to achieve the targeted rate
- Inflation targeting in a way nothing but forecasting inflation. Price index is used to measure inflation. In the case of the inflation targeting also a particular price index needs to be selected. Generally consumer price index is used
- Many countries are experimenting with inflation targeting . The Reserve Bank of India has announced an inflation target 4% with + / -2 percent as the tolerance level. This inflation target is for a period of five years from 2016-2021. The government sets the target in consultation with the Reserve Bank of India
- Inflation rate in the range of 2% to 6% is considered as a reasonable rate. Such a rate is expected provide stability to encourage consumption and investment.

The success of inflation targeting depends on a number of factors

1. **Well developed financial system**
2. **Autonomy for the central bank**
3. **Adequate and accurate availability of data**
4. **Sufficient technological advancement and technical capacity to forecast inflation**
5. **Non - interference of the government in the working of the central bank**
6. **Deregulation of the administration price mechanism**

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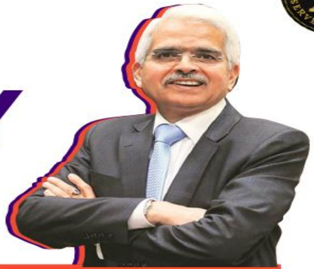
RBI MONETARY POLICY

DECEMBER 2020



Repo Rate	Reverse Repo	Rate Stance
4%	3.35%	Accommodative
Unchanged	Unchanged	Maintained

Key Points:

- The **Marginal Standing Facility (MSF) Rate & Bank Rate** remain unchanged at **4.25%.**
- **CRR** remains at **3% & SLR at 18%.**
- RBI proposes to enhance limits for contactless card payments from ₹2000 to ₹5000 from Jan 2021.
- **RTGS systems** will soon be made **24x7** in the next few days.
- Governor proposes to put in place a criterion for **NBFC dividend distribution**, introduces **risk-based audit** in large NBFCs & co-op banks.
- **Commercial and co-operative banks** will retain profits earned & will not give out dividends for FY21.
- On-tap TLTRO will be expanded to cover other stressed sectors in tandem with ECLGS scheme.
- **Real GDP growth for 2021** is projected at **-7.5%.**