# Monetary Policy

# Monetary Policy

- **Definition:** Tools used by a central bank to manage the overall money supply and interest rates, aiming to foster economic stability and growth.
- **Responsibility in India:** The Reserve Bank of India (RBI) manages India's monetary policy in accordance with the Reserve Bank of India Act of 1934.
- **Primary Objective:** To achieve price stability while supporting sustainable economic growth along with achieving full employment levels

## India's Monetary Policy Framework

- **Foundation:** The Reserve Bank of India Act of 1934 (amended in 2016) established a flexible inflation targeting framework for monetary policy.
- **Diverse Objectives:** The Chakravarty Committee highlights that India's monetary policy must balance several goals: price stability, economic growth, equity, social justice, and supporting new financial ventures.
- **Inflation as Anchor:** The Urjit Patel report supports using inflation as the primary focus of monetary policy. It recommends setting a 4% inflation target with a tolerance band of +/- 2%. This emphasis on inflation control aims to protect the purchasing power of those most vulnerable, as food and fuel (necessities) significantly impact them.
- **Inflation Target:**
    - The Central Government, with RBI input, sets the inflation target (using the Consumer Price Index) every five years.
    - The current target is 4% CPI inflation, with a tolerance band of 2-6%. This target is in place until March 31, 2026.

| | Monetary Policy | Fiscal Policy |
|---|---|---|
| **Tool** | Interest rates | Tax and government spending |
| **Effect** | Cost of borrowing/mortgages | Budget deficit |
| **Distribution** | Higher interest rates hit homeowners but benefit savers | Depends which taxes you raise. |
| **Exchange rate** | Higher interest rates cause appreciation | No effect on exchange rate |
| **Supply-side** | Limited impact | Higher taxes may affect incentives to work |
| **Politics** | Monetary policy set by independent Central Bank | Changing tax and government spending highly political. |
| **Liquidity trap** | Cuts in interest rates may not work in liquidity trap | Fiscal policy advised in very deep recessions |

- **Monetary Policy Committee (MPC):** A six-member MPC (established by the RBI Act) sets the policy interest rate to achieve the inflation target.



## Failure to Maintain Inflation Target

- **Definition of Failure:** Inflation remains outside the established tolerance band (currently 2-6%) for three consecutive quarters. This can mean inflation being consistently too high or too low.
- **RBI's Responsibility:** If the inflation target is missed, the RBI must submit a report to the Central Government explaining:
    - Why the target was missed.
    - Proposed actions to correct the situation.
    - Estimated timeline for returning inflation to within the target range.

## Monetary Policy Operating Framework

- **Goal:** Aligning the weighted average call rate (WACR) with the policy repo rate through active liquidity management.
- **Purpose:** Facilitate the transmission of interest rate changes throughout the financial system, influencing aggregate demand, which in turn impacts inflation and growth.

## Concerns Regarding Inflation Targeting in India

- **Theoretical Basis:** The model underlying inflation targeting assumes inflation arises from economic "overheating" and is cured by raising interest rates. However, the "natural level of output" this is based on is unobservable and hard to verify.
- **Questionable Success:** While inflation has remained within the target band, it fell even before inflation targeting was adopted in 2016. This, and the food-price led decline, suggest factors beyond inflation targeting may be at play.
- **Contradictions with Recent Experience:**
  - Inflation flared up *after* the COVID-19 lockdown, making the "overheating" theory unlikely. Food price disruptions provide a better explanation.
  - Economic growth has actually *declined* under inflation targeting, contradicting the claim that low inflation benefits growth.
  - High interest rates (a tool of inflation targeting) may have harmed investment.
  - Exports and employment have not improved significantly.
  - Rise in non-performing assets (NPAs) suggests a potential conflict between inflation targeting and financial stability.

**Conclusion:** The success of inflation targeting in India is debatable. Its theoretical foundation has weaknesses and recent economic trends raise questions about its effectiveness.

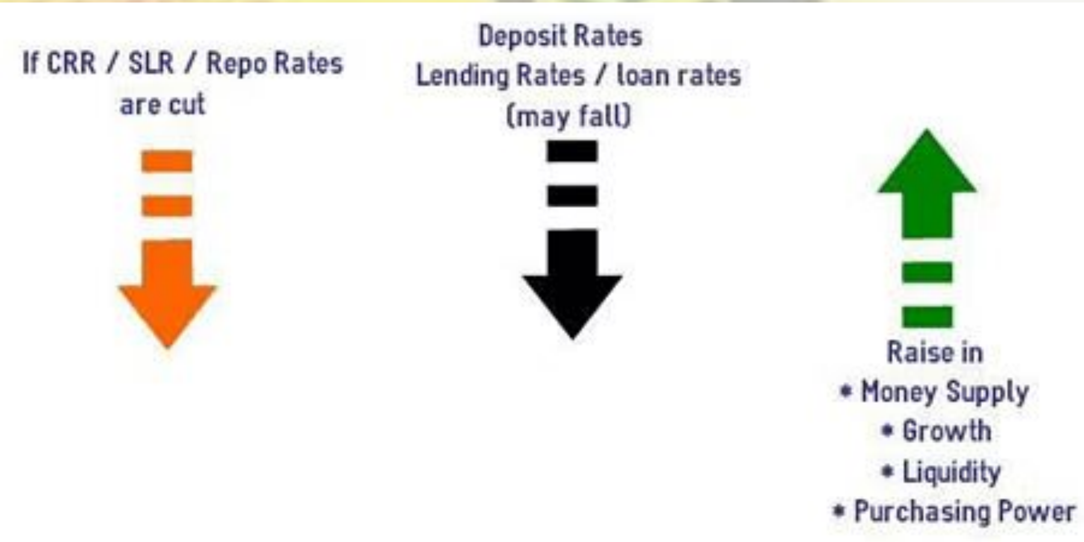
# Monetary Policy Committee (MPC)

- **Purpose:** To set the policy repo rate in order to achieve the established inflation target.
- **Formation:**
  - Six-member committee established by the Central Government under the amended RBI Act of 1934.
  - Includes the RBI Governor (Chairperson), RBI Deputy Governor in charge of Monetary Policy, one RBI officer, and three external experts appointed by the government.
- **Requirements:**
  - Meets at least four times per year.
  - Quorum of four members required for decisions.
  - In case of a tie, the RBI Governor has the deciding vote.
  - Each member provides a written statement explaining their vote.

| Quantitative Instruments | Basis | Qualitative Instruments |
|---|---|---|
| These are the instruments of monetary policy that affect overall supply of money/credit in the economy. | **Meaning** | These instruments are used to regulate the direction of credit. |
| Traditional methods of control | **Alternative Name** | Selective methods of control |
| (*i*) Bank rate<br>(*ii*) Repo Rate<br>(*iii*) Reverse Repo Rate<br>(*iv*) Open market operation<br>(*v*) Cash reserve ratio<br>(*vi*) Statutory liquidity ratio | **Instruments** | (*i*) Marginal requirement<br>(*ii*) Moral suasion<br>(*iii*) Selective credit control |

## Monetary Policy Tools

- **Liquidity Adjustment Facility (LAF):** It allows banks to borrow money through repurchase agreements (repos) or to make loans to the RBI through reverse repo agreements.
- **Repo Rate:** The repo rate is the rate at which the RBI lends money to banks to meet their short-term funding needs.
- **Reverse Repo Rate:** The interest rate at which the Reserve Bank absorbs liquidity from banks against the collateral of eligible government securities under the LAF.
- **Statutory Liquidity Ratio (SLR):** It is the minimum percentage of deposits that a commercial bank has to maintain in the form of liquid cash, gold or other securities.
- **Cash Reserve Ratio (CRR):** CRR is a percentage of total deposits that the banks have to maintain as liquid cash with the RBI.



- **Marginal Facility (MSF) Rate:** It is the penal rate at which banks can borrow, on an overnight basis, from the RBI by dipping into their SLR portfolio.
- **Bank Rate:** The Bank Rate acts as the penal rate charged on banks for shortfalls in meeting their reserve requirements (cash reserve ratio and statutory liquidity ratio).
- **Open Market Operations (OMOs):** These include outright purchase/sale of government securities by the RBI for injection/absorption of durable liquidity in the banking system.

## Monetary Policy Stances



The MPC uses these stances to signal its policy direction to the market:

- **Accommodative:** Focuses on boosting economic growth. The central bank is likely to lower interest rates to increase the money supply. Used when growth needs support and inflation isn't an immediate threat.
- **Neutral:** Balances growth and inflation concerns. Interest rates could move in either direction depending on economic data.
- **Hawkish:** Prioritizes controlling inflation. The central bank is likely to raise interest rates to reduce the money supply and tame demand. Used when inflation is a significant concern.
- **Calibrated Tightening:** Indicates a bias toward increasing interest rates, but in a gradual or measured way. Rate cuts are unlikely in this stance.

| Fiscal policy (FP) stance | Recession (↓ GDP) | Expansion (↑ GDP) | Outcome |
|---|---|---|---|
| Pro-cyclical | Contractionary FP<br>↓ Govt. Expenditure<br>or /and<br>↑ Taxes | Expansionary FP<br>↑ Govt. Expenditure<br>or/and<br>↓ Taxes | Deepens recessions and amplifies expansions, thereby increasing fluctuations in the business cycle. |
| Counter-cyclical | Expansionary FP<br>↑ Govt. Expenditure<br>or/and<br>↓ Taxes | Contractionary FP<br>↓ Govt. Expenditure<br>or /and<br>↑ Taxes | Softens the recession and moderates the expansions, thereby decreasing fluctuations in the business cycle. |

| Expansionary Monetary Policy | Contractionary Monetary Policy |
|---|---|
| **1. Goal**<br>Expansionary monetary policy aims to stimulate economic growth and increase aggregate demand by lowering interest rates, increasing the money supply, and encouraging borrowing and investment. | **1. Goal**<br>Contractionary monetary policy, on the other hand, aims to slow down the economy and control inflation by raising interest rates, reducing the money supply, and discouraging borrowing and spending. |
| **2. Interest Rate**<br>Expansionary monetary policy typically involves lowering interest rates to make borrowing more affordable, which encourages spending and investment. | **2. Interest Rate**<br>Contractionary monetary policy, on the other hand, involves raising interest rates to make borrowing more expensive, which can discourage spending and investment. |
| **3. Impact on Inflation**<br>Expansionary monetary policy can potentially lead to higher inflation if the increased money supply fuels excessive spending. | **3. Impact on Inflation**<br>Contractionary monetary policy, on the other hand, aims to control inflation by reducing the money supply and slowing down economic activity. |
| **4. Timing**<br>Expansionary monetary policy is generally implemented during periods of economic slowdown or recession to stimulate growth. | **4. Timing**<br>Contractionary monetary policy is typically employed during periods of high inflation or economic overheating to cool down the economy. |

# Expansionary and contractionary monetary policy: A summary: Table 16.2

## (a) An expansionary policy

Reserve Bank Board decreases the cash rate → Other interest rates fall → Investment, consumption and net exports increase → The AD curve shifts to the right by *more* than it otherwise would have → Real GDP and the price level rise by *more* than they would have without policy

## (b) A contractionary policy

Reserve Bank Board increases the cash rate → Other interest rates rise → Investment, consumption and net exports decrease → The AD curve shifts to the right by *less* than it otherwise would have → Real GDP and the price level rise by *less* than they would have without policy

# IMPORTANT DEFINITIONS



- Quantitative easing - It involves printing fresh currency to overcome debt . Lending is made easier . May lead to Inflation.
- Liquidity trap - It is a situation when lowering interest rates does not revive demand and growth.It happens during recession.
- Money supply - It indicates the total value of monetary assets available in an economy at a given point of time.

## Key Developments in Indian Banking

- **1949:** The Reserve Bank of India (RBI) was nationalized to strengthen its role as the central bank. The Banking Act was passed for coordinated regulation of the banking sector.
- **1955:** The Imperial Bank of India was partially nationalized as the State Bank of India (SBI) to extend banking to rural areas.
- **1980:** Major private banks were nationalized.

## RBI: The Central Bank

- **Established:** 1935
- **Ownership:** Fully nationalized since 1949
- **Governance:** Central Board of Directors (includes Governor, Deputy Governors, government, and local board representatives)

## RBI Functions:

- **Banker to Government:** Acts as agent and advisor to central and state governments.
- **Banker's Bank:** Provides accounts and services to other banks.
- **Lender of Last Resort:** Supports banks facing liquidity issues.
- **Controller of Credit:** Manages money supply and interest rates.
- **Debt Manager:** Manages government debt.
- **Decides benchmark interest rate:** A six-member Monetary Policy Committee, headed by RBI Governor, decides the benchmark repo rate.
- **Custodian of Foreign Reserves:** Manages the country's foreign exchange reserves.

The balance between RBI independence and government oversight in pursuit of economic goals.



## Historical Context

- **Functional vs. Goal Independence:** Initially, RBI had functional independence (control over tools and their use) but goals were set by the government. The debate shifted to a narrow focus on inflation control.
- **RBI's Limited Autonomy:** A 2014 study ranked the RBI as the least independent among major central banks. While inflation targeting and formation of the Monetary Policy Committee likely improved this, recent vacancies on the RBI board raise concerns about deliberation and decision-making.

## RBI's Grievances:

- **Limited Control Over Public Sector Banks (PSBs):** The RBI wants more power despite already having oversight mechanisms (board nominees, inspections, ability to orchestrate mergers).
- **Disputes over Dividend Payments:** The RBI feels the government shouldn't dictate the amount of surplus it can pay as dividends.
- **Opposition to Separate Payments Regulator:** The RBI is unhappy with the suggestion of a separate body for regulating payments.

## Section 7 of the RBI Act

- Grants the government power to issue directions to the RBI in the public interest.
- Raises questions about the limits of government intervention and the internal balance of power between the RBI Governor and board.
- Thankfully, Section 7 has never been formally invoked.

**Overall:** The RBI enjoys some independence but the exact boundaries of its autonomy in relation to the government remain a point of contention.

## Addressing RBI's Challenges

- **Acknowledge Uncertainty:** In a complex economic environment, there will always be debates over the best policy tools and their interpretation.
- **Balance Autonomy with Accountability:** Both independence and responsibility are crucial. The RBI needs a forum to explain and justify its decisions within the framework of democratic processes.
- **Learning from Global Examples:** Different countries have tailored approaches to central bank governance. The US model, where the Federal Reserve Chairman presents to Congress, offers a good example of transparency without undermining autonomy.
- **Create a Structured Forum:** India needs a dedicated space for dialogue that balances RBI's independence with the need to avoid unchecked authority or direct political interference