Central Banking and Monetary Policy

Structure of Reserve Bank of India

- The RBI, as the central bank of the country, is the centre of the Indian financial and monetary system.
- It started functioning from April 1, 1935 on the terms of the Reserve Bank of India Act, 1934
- The Governor and all the Deputy Governors of the Bank are appointed by the central government
- The Bank is managed by a Central Board of Directors, four Local Boards of Directors, and a committee of the Central Board of Directors
- The final control of the Bank vests in the Central Board which comprises the Governor, four Deputy Governors, and fifteen Directors nominated by the central government.

Objectives of RBI

- To maintain monetary stability so that the business and economic life can deliver welfare gains of a properly functioning mixed economy.
- To maintain financial stability and ensure sound financial institutions so that monetary stability can be safely pursued and economic units can conduct their business with confidence.
- To maintain stable payments system so that financial transactions can be safely and efficiently executed.
- To promote the development of financial infrastructure of markets and systems, and to enable it to operate efficiently i.e., to play a leading role in developing a sound financial system so that it can discharge its regulatory function efficiently.
- To ensure that credit allocation by the financial system broadly reflects the national economic priorities and societal concerns.
- To regulate the overall volume of money and credit in the economy with a view to ensure a reasonable degree of price stability.

Functions of RBI

- **Note Issuing Authority**
  - The RBI has, since its inception, the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins, and coins of smaller denominations.
  - At present, the Bank issues notes in the following denominations: Rs 5, 10, 20, 50, 100, 500 and 2000
- **Government Banker**
  - The RBI is the banker to the Central and state governments
  - It provides to the governments all banking services such as acceptance of deposits, withdrawal of funds by cheques, making payments as well as receipts and collection of payments on behalf of the government, transfer of funds, and management of public debt

Functions of RBI Cont…

- **Management of Public Debt**
  - The Reserve Bank manages the public debt and issues new loans on behalf of the Central and State Governments. It involves issue and retirement of rupee loans, interest payment on the loan and operational matters about debt certificates and their registration.
- **Bankers' Bank**
  - The Bank controls the volume of reserves of commercial banks and thereby determines the deposits/credit creating ability of the banks.
  - The Reserve Bank opens current accounts of banks with itself, enabling these banks to maintain cash reserves as well as to carry out inter-bank transactions through these accounts.
  - Inter-bank accounts can also be settled by transfer of money through electronic fund transfer system, such as, the Real Time Gross Settlement System (RTGS).
  - The banks hold a part or all of their reserves with the RBI. Similarly, in times of need, the banks borrow funds from the RBI.

Functions of RBI Cont…

- **Supervising Authority**
  - Issues licences for the establishment of new banks
  - Issues licences for the setting up of bank branches
  - Prescribes minimum requirements regarding paid-up capital and reserves, transfer to reserve fund, and maintenance of cash reserves and other liquid assets
  - Inspects the working of banks in India as well as abroad in respect of their organisational set-up, branch expansion, mobilisation of deposits, investments, and credit portfolio management, credit appraisal, region-wise performance, profit planning, manpower planning and training
  - Conducts investigations, from time to time, into complaints, irregularities, and frauds in respect of banks
  - Controls appointment, re-appointment, termination of appointment of the Chairman and chief executive officers of private sector banks
  - Approves or force amalgamations

Functions of RBI Cont…

- **Exchange Control (EC) Authority**
  - Administers the foreign exchange control
  - Chooses the exchange rate system and fix or manage the exchange rate between the rupee and other currencies
  - Manages exchange reserves
  - Interacts or negotiates with the monetary authorities of the Sterling Area, Asian Clearing Union, and other countries, and with international financial institutions such as the IMF, World Bank, and Asian Development Bank.

Functions of RBI Cont…

- **Formulating Prudential Norms**
  - RBI formulates various prudential norms to create and maintain a stable, efficient, and well-functioning financial system in India.
- **Promoter of the Financial System**
  - RBI has been rendering 'developmental' or 'promotional' services which have strengthened the country's banking and financial structure
  - Helps in mobilising savings and directing credit flows to desired channels
  - Provides concessional loans to various priority sectors
  - Establishes specific institutions like NABARD to develop agricultural sector

Functions of RBI Cont…

- **Regulation and Supervision of Payment System**
  - Takes steps towards integrating the payment system with the settlement systems for government securities and foreign exchange
  - To facilitate settlement of Government securities transactions, it created the Negotiated Dealing System, a screen-based trading platform
  - It created a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) as a Committee of the Central Board. A new department called the Department of Payment and Settlement Systems (DPSS) was constituted to assist the BPSS in performing its functions
- **Regulator of Money and Credit**
  - The function of formulating and conducting monetary policy is of paramount importance for any Central Bank.

Objectives of Monetary Policy in India

- To accelerate economic development in an environment of reasonable price stability,
- To develop appropriate institutional set-up to aid this process
- To help in achieving the financial market stability

Framework for Monetary Policy in India

- Money supply can't be the only control variable of monetary policy as it is not exogenous i.e., it is not fully under their control must have led them to adopt the approach as indicated.
- There are two major elements which are virtually outside our control, namely (**a) the increase in monetary supply corresponding to inward remittances of foreign exchange, and (b) the requirement of credit for financing the purchase of food grains.**
- Monetary policy instruments ------- Intermediate Targets----Output
- RBI regards money supply and the volume of bank credit as the two major intermediate variables

Monetary Policy Instruments

- **Open Market Operations (OMOs)**
  - Sale/ purchase of Government securities to/ from the market with an objective to adjust the rupee liquidity conditions in the market on a durable basis.
  - Excess liquidity in the market tends to sale of securities thereby sucking out the rupee liquidity.
  - Illiquidity condition tends to buy securities from the market, thereby releasing liquidity into the market.
- **Bank Rate**
  - It is the rate is the rate at which central bank allows finance to commercial banks.

Monetary Policy Instruments Cont…

- **Cash Reserve Ratio (CRR)**
  - The CRR refers to the cash which banks have to maintain with the RBI as a certain percentage of their demand and time liabilities.
- **Statutory Liquidity Ratio (SLR)**
  - It is the percentage of total deposits banks have to invest in government bonds and other approved securities.
  - There are three objectives behind the use of SLR: (a) to restrict expansion of bank credit, (b) to augment banks' investment in government securities, and (c) to ensure solvency of banks.

Monetary Policy Instruments Cont…

- **Direct Credit Allocation and Credit**
  - Controls the distribution or allocation of credit among different sectors, borrowers, and users through the fixation of specific and direct quantitative credit ceilings or credit targets
  - Restricts drawing power of borrowers under cash credit limits
  - Certain prescribed credit-deposit ratio in respect of their rural and semi-urban branches separately
- **Selective Credit Controls**
  - They are used to reduce the supply of credit in certain directions and to encourage it in desired directions

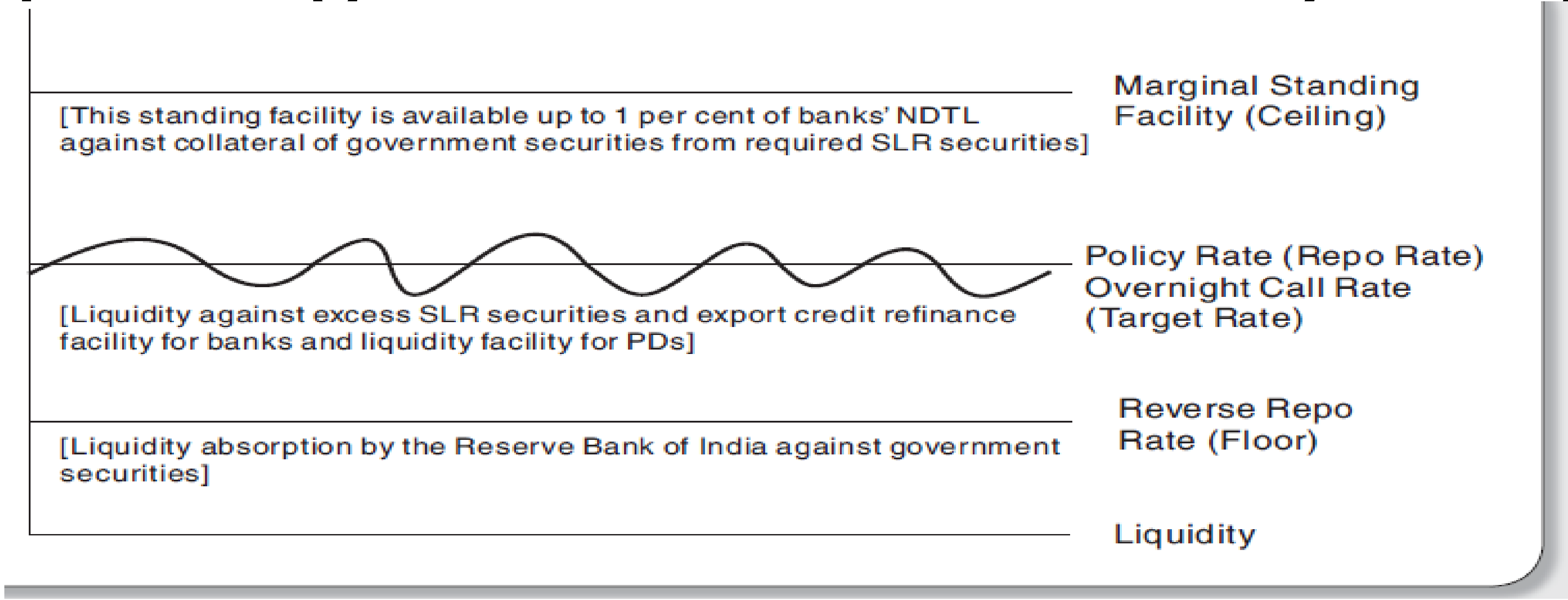
Monetary Policy Instruments Cont…

- **Credit Authorisation Scheme**
  - Under this scheme Credit Monitory Arrangement (CMA) was introduced. As per this scheme, credit proposals for Rs five crore and above in the case of working capital, and Rs two crore and above in the case of term loans, had to be submitted to the RBI for post-sanction scrutiny.
- **Process of Credit Planning**
  - Each bank is required to prepare realistic annual credit budget incorporating estimates of volume and growth of deposits and other resources, and of demand for credit.
- **Moral Suasion**
  - It takes the form of writing letters and holding discussions between the RBI and the banks about trends in the economy in general and in money, credit and finance in particular, and about the measures which ought to be taken from time to time in the light of national objectives

Monetary Policy Instruments Cont…

- **Liquidity Adjustment Facility (LAF)**
  - LAF enables liquidity management on a day to day basis
  - The operations of LAF are conducted by way of repurchase agreements (repos and reverse repos) with RBI being the counter-party to all the transactions.
  - Repo or ready forward contact is an instrument for borrowing funds by selling securities with an agreement to repurchase the said securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed.
  - The reverse of the repo transaction is called ‘reverse repo’ which is lending of funds against buying of securities with an agreement to resell the said securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.
  - The interest rate in LAF is fixed by the RBI from time to time

Operating Procedure of Monetary Policy



The new operating procedure retained the essential features of the earlier LAF framework with the following key modifications. First, the weighted average overnight call money rate was explicitly recognised as the operating target of monetary policy. Second, the repo rate was made the only one independently varying policy rate. Third, a new Marginal Standing Facility (MSF) was instituted under which scheduled commercial banks (SCBs) could borrow overnight at their discretion up to one per cent of their respective net demand and time liabilities (NDTL).