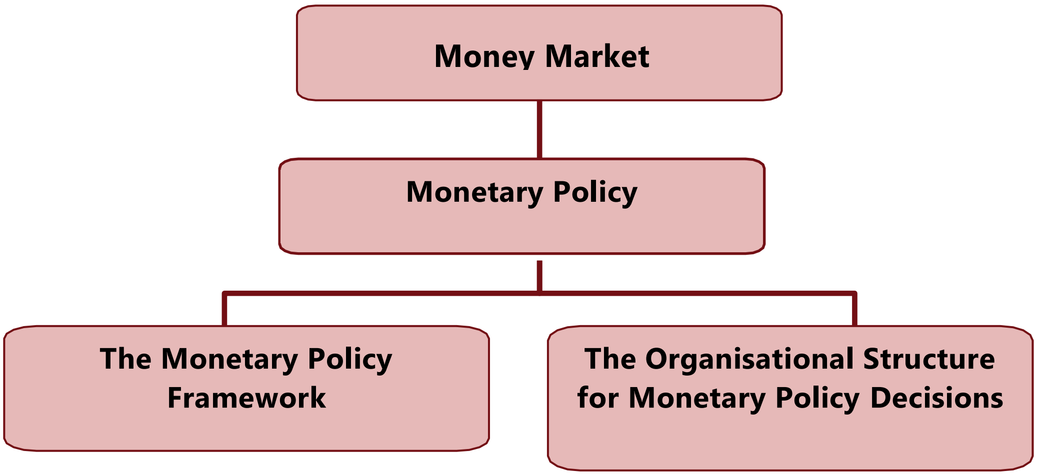
UNIT - 3: MONETARY POLICY

LEARNING OUTCOMES

After studying this Unit, you will be able to –

- Define monetary policy and describe its objectives
- Elucidate different components of the monetary policy framework
- Illustrate the analytics of monetary policy
- Explain the operating procedures and instruments of monetary policy, and
- Describe the organizational structure for monetary policy decisions

UNIT OVERVIEW



3.1 INTRODUCTION

We observe that the Reserve Bank of India is occasionally manipulating policy rates for manoeuvring liquidity conditions with reasons thereof explicitly notified. In fact, we have only a limited understanding of the monetary phenomena which could strengthen or paralyse the domestic economy. The discussion that follows is an attempt to throw light on the well-acknowledged monetary measures undertaken by governments to fight economic instability.

3.2 MONETARY POLICY DEFINED

Reserve Bank of India uses monetary policy to manage economic fluctuations and achieve price stability, which means that inflation is low and stable. 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.

3.3 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.

3.3.1 The Objectives of Monetary Policy

The objectives set for monetary policy are important because they provide explicit guidance to policymakers. 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.

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

(i) maintenance the economic growth,

(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.

3.3.2 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

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.

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

- 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.

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. This is an important channel for those that are liquidity constrained (for example, those who have already borrowed up to the maximum that banks will provide).
- 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.

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)

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.

- 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.

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.

- 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.

3.3.3 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.

Reserve Ratio

Banks are required to keep aside a set percentage of cash reserves or RBI approved assets. Reserve ratio is of two types:

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.

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 latter 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.

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.

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.

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

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

Market Stabilisation Scheme (MSS) -

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 rep policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities.

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

3.4 THE ORGANISATIONAL STRUCTURE FOR MONETARY POLICY DECISIONS

We have discussed above the instruments of monetary policy. An understanding of the organizational 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. The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework'.

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:
    - (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.

The choice of CPI was made because it closely reflects cost of living and has larger influence on inflation expectations compared to other anchors. With this step, India is following countries such as the New Zealand, the USA, the UK, European Union, and Brazil. In recent times many countries are moving away from this approach and are targeting nominal GDP growth.

3.5 CONCLUSION

The theoretical exposition of monetary policy might appear uncomplicated. However, the choice of a monetary policy action is rather complicated in view of the surrounding uncertainties and the need for exercising complex judgment to balance growth and inflation concerns. Additional complexities arise in the case of an emerging market like India. There are many challenges which need to be addressed, such as rudimentary and non-competitive financial systems, lack of integrated money and interbank markets, external uncertainties and issues related to operational autonomy of the central bank. Explicit inflation targeting requires a good degree of operational autonomy for the central bank and a system in which there is a good coordination between fiscal and monetary authorities.

SUMMARY

- Monetary policy refers to the use of monetary policy instruments which are at the disposal of the central bank to regulate the availability, cost and use of money and credit so as to promote economic growth, price stability, optimum levels of output and employment, balance of payments equilibrium, stable currency or any other goal of government's economic policy.
- The monetary policy framework which has three basic components, viz. the objectives of monetary policy, the analytics of monetary policy which focus on the transmission mechanism, and the operating procedure which focuses on the operating targets and instruments.
- Though multiple objectives are pursued, the most commonly pursued objectives of monetary policy of the central banks across the world has become maintenance of price stability (or controlling inflation) and achievement of economic growth.
- The process or channels through which the evolution of monetary aggregates affects the level of production and price level is known as 'monetary transmission mechanism' i.e how they impact real variables such as aggregate output and employment.
- There are mainly four different mechanisms, namely, the interest rate channel, the exchange rate channel, the quantum channel, and the asset price channel.
- A contractionary monetary policy-induced increase in interest rates increases the cost of capital and the real cost of borrowing for firms and households who respond by cut back on their investment and consumption respectively.

- The exchange rate channel works through expenditure switching between domestic and foreign goods on account of appreciation / depreciation of the domestic currency with its impact on net exports and consequently on domestic output and employment.
- Two distinct credit channels- the bank lending channel and the balance sheet channel-operate by altering access of firm and household to bank credit and by the effect of monetary policy on the firm's balance sheet respectively.
- Asset prices generate important wealth effects that impact, through spending, output and employment.
- The operating framework of monetary policy relates to all aspects of implementation namely, choosing the operating target, choosing the intermediate target, and choosing the policy instruments.
- The day-to-day implementation of monetary policy by central banks through various instruments is referred to as 'operating procedures'.
- Monetary policy instruments are the various tools that a central bank can use to influence money market and credit conditions and pursue its monetary policy objectives. There are direct instruments and indirect instruments.
- The Cash Reserve Ratio (CRR) refers to the fraction of the total net demand and time liabilities (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with the Reserve Bank irrespective of its size or financial position.
- The Statutory Liquidity Ratio (SLR) is what the scheduled commercial banks in India are required to maintain as a stipulated percentage of their total Demand and Time Liabilities (DTL) / Net DTL (NDTL) in Cash, Gold or approved investments in securities.
- On the basis of the recommendations of Narsimham Committee on banking sector reforms the RBI introduced Liquidity Adjustment Facility (LAF) under which RBI provides financial accommodation to the commercial banks through repos/reverse repos.
- Repurchase Options or in short Repo, is defined as 'an instrument for borrowing funds by selling securities with an agreement to repurchase the securities on a mutually agreed future date at an agreed price which includes interest for the funds borrowed'.
- In India, the fixed repo rate quoted for sovereign securities in the overnight segment of Liquidity Adjustment Facility (LAF) is considered as the 'policy rate'.
- Repo or repurchase option is a collaterised lending because banks borrow money from Reserve bank of India to fulfil their short term monetary requirements by selling

securities to RBI with an explicit agreement to repurchase the same at predetermined date and at a fixed rate. The rate charged by RBI for this transaction is called the 'repo rate'.

- Reverse Repo is defined as an instrument for lending funds by purchasing securities with an agreement to resell the securities on a mutually agreed future date at an agreed price which includes interest for the funds lent.
- The Marginal Standing Facility (MSF) refers to the facility under which scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF window by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit.
- Under the Market Stabilisation Scheme (MSS) the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities.
- Bank Rate refers to "the standard rate at which the Reserve Bank is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act.
- OMOs is a general term used for market operations conducted by the Reserve Bank of India by way of sale/ purchase of Government securities to/ from the market with an objective to adjust the rupee liquidity conditions in the market on a regular basis.
- The Monetary Policy Committee (MPC) consisting of six members shall determine the policy rate to achieve the inflation target through debate and majority vote by a panel of experts.
- The Monetary Policy Framework Agreement is an agreement reached between the Government of India and the Reserve Bank of India (RBI) to keep the Consumer Price Index CPI) inflation rate between 2 to 6 per cent.
- Choice of a monetary policy action is rather complex in view of the surrounding uncertainties and the need for exercising trade-offs between growth and inflation concerns. Additional complexities arise in the case of an emerging market like India where inflation is influenced by factors such as international petroleum prices and food prices.

TEST YOUR KNOWLEDGE

Multiple Choice Type Questions

1. *Which of the following is the function of monetary policy?*
   - (a) *regulate the exchange rate and keep it stable*
   - (b) *regulate the movement of credit to the corporate sector*
   - (c) *regulate the level of production and prices*
   - (d) *regulate the availability, cost and use of money and credit*
2. *The main objective of monetary policy in India is _______:*
   - (a) *reduce food shortages to achieve stability*
   - (b) *economic growth with price stability*
   - (c) *overall monetary stability in the banking system*
   - (d) *reduction of poverty and unemployment*
3. *The monetary transmission mechanism refers to*
   - (a) *how money gets circulated in different sectors of the economy post monetary policy*
   - (b) *the ratio of nominal interest and real interest rates consequent on a monetary policy*
   - (c) *the process or channels through which the evolution of monetary aggregates affects the level of product and prices*
   - (d) *none of the above*
4. *A contractionary monetary policy-induced increase in interest rates*
   - (a) *increases the cost of capital and the real cost of borrowing for firms*
   - (b) *increases the cost of capital and the real cost of borrowing for firms and households*
   - (c) *decreases the cost of capital and the real cost of borrowing for firms*
   - (d) *has no interest rate effect on firms and households*

5. *During deflation*

   (a) *the RBI reduces the CRR in order to enable the banks to expand credit and increase the supply of money available in the economy*

   (b) *the RBI increases the CRR in order to enable the banks to expand credit and increase the supply of money available in the economy*

   (c) *the RBI reduces the CRR in order to enable the banks to contract credit and increase the supply of money available in the economy*

   (d) *the RBI reduces the CRR but increase SLR in order to enable the banks to contract credit and increase the supply of money available in the economy*

6. *Which of the following statements is correct?*

   (a) *The governor of the RBI in consultation with the Ministry of Finance decides the policy rate and implements the same*

   (b) *While CRR has to be maintained by banks as cash with the RBI, the SLR requires holding of approved assets by the bank itself*

   (c) *When repo rates increase, it means that banks can now borrow money through open market operations (OMO)*

   (d) *None of the above*

7. *RBI provides financial accommodation to the commercial banks through repos/reverse repos under*

   (a) *Market Stabilisation Scheme (MSS)*

   (b) *The Marginal Standing Facility (MSF)*

   (c) *Liquidity Adjustment Facility (LAF).*

   (d) *Statutory Liquidity Ratio (SLR)*

8. *_____________is a money market instrument, which enables collateralised short term borrowing and lending through sale/purchase operations in debt instruments.*

   (a) *OMO*

   (b) *CRR*

   (c) *SLR*

   (d) *Repo*

9. *In India, the term 'Policy rate' refers to*

   (a) *The bank rate prescribed by the RBI in its half yearly monetary policy statement*

   (b) *The CRR and SLR prescribed by RBI in its monetary policy statement*

   (c) *the fixed repo rate quoted for sovereign securities in the overnight segment of Liquidity Adjustment Facility (LAF)*

   (d) *the fixed repo rate quoted for sovereign securities in the overnight segment of Marginal Standing Facility (MSF)*

10. *Reverse repo operation takes place when*

    (a) *RBI borrows money from banks by giving them securities*

    (b) *banks borrow money from RBI by giving them securities*

    (c) *banks borrow money in the overnight segment of the money market*

    (d) *RBI borrows money from the central government*

11. *The Monetary Policy Framework Agreement is on*

    (a) *the maximum repo rate that RBI can charge from government*

    (b) *the maximum tolerable inflation rate that RBI should target to achieve price stability.*

    (c) *the maximum repo rate that RBI can charge from the commercial banks*

    (d) *the maximum reverse repo rate that RBI can charge from the commercial banks*

12. *An open market operation is an instrument of monetary policy which involves buying or selling of ________from or to the public and banks*

    (a) *bonds and bills of exchange*

    (b) *debentures and shares*

    (c) *government securities*

    (d) *none of these*

13. *Which statement (s) is (are) true about Monetary Policy Committee?*

    I. *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 and for setting up a Monetary Policy Committee*

II. *The Monetary Policy Committee shall determine the policy rate through debate and majority vote by a panel of experts required to achieve the inflation target.*

III. *The Monetary Policy Committee shall determine the policy rate through consensus from the governor of RBI*

IV. *The Monetary Policy Committee shall determine the policy rate through debate and majority vote by a panel of bankers chosen for eth purpose*

(a) *I only*

(b) *I and II only*

(c) *III and IV*

(d) *III only*

ANSWERS

1.	**(d)**	2	**(b)**	3	**(c)**	4.	**(b)**	5.	**(a)**	6.	**(b)**
7.	**(c)**	8.	**(d)**	9.	**(c)**	10.	**(a)**	11.	**(b)**	12.	**(c)**
13.	**(b)**										

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