Monetary Policy

- it is the process by which
  - monetary authority of a country controls the supply of money
  - by targeting a rate of interest for the purpose of promoting economic growth and stability
- goals
  - stabilise the prices
  - reduce the unemployment levels
- types
  - **Expansionary**
  - **Contractionary**

Role of Central Bank

- Functions
  - Custody and management of Foreign Exchange Reserves
  - Acting as a bank to the banker
  - Acting as a bank to the government
  - Leader of the last resort
  - Controller of credit
    - exercises discretionary control over the monetary system of the country
    - commands an imp. position in the monetary and banking structure of country
- Monetary policy
  - **Announced six times a year**
  - Determines the supply of money in the economy
  - Determines the rate of interest charged by bank
  - Contains an economic overview and presents future forecasts
- Instruments
  - Quantitative
    - bank rate
    - statutory liquidity ratio
    - cash reserve ratio
    - repo rate
    - reverse repo rate
    - open market operations
  - Qualitative
    - Margin requirements
    - Consumer credit regulation and guidelines
    - moral suasion
      - moral request by bank to control it or not
    - direct action

Bank Rate

- Refers to the official interest rate at which RBI provides loans to the banking system

- It includes
    - commercial/cooperative banks
    - development banks etc.
- such loans are given out by
    - direct lending
    - rediscounting (buying back) the bills of commercial banks and treasury bills
- **Bank rate is also known as discount rate**
- Objective
    - When RBI increases the bank rate, the cost of borrowing for banks rises
    - this credit volume gets reduced leading to decline in supply of money
    - thus, **increase in bank rate reflects tightening of RBI monetary policy**

Repo Rate

- Repurchase rate
- Rate at which RBI lends to banks for short periods
- Done by RBI buying government bonds from banks with an agreement to sell them back at a fixed rate
- Objective
    - inject liquidity in the system
    - **increased repo rate -> expensive for banks to borrow**
    - **decreased repo rate -> cheaper for banks to borrow**

Bank Rate vs Repo Rate

- Repo rate is a short term measure and it refers to short-term lonas and used for controlling amount of money in market
- Bank rate is a long term measure and is governed by the long-term monetary policy of RBI

Reverse Repo Rate

- Rate of interest at which the RBI borrows funds from other banks in the short term
- Done by RBI selling **government bonds** or **securities** to banks with commitment to buy them back at a future date
- Bank use reverse repo facility to **deposit their short term excess funds with RBI** and **earn interest for it**
- RBI can reduce liquidity in banking system by increasing the rate at which it borrows from banks
- Procedure
    - When RBI increases the reverse repo, it means that now RBI will provide extra interest on the money which it borrows from the banks.
    - An increase in reverse repo rate means that banks earn higher returns by lending to RBI
    - This indicates a hike in deposit rates
    - pushes up interest rates

Open Market Operations

- **Purchase and Sale of the Government Securities by RBI from/to market**
- When there is excess of liquidity RBI resorts to **sale of G-secs** to suck out rupee from system
- When there is liquidity crunch, RBI buys securities from the market in order to release liquidity
- Objective
  - carried out to adjust liquidity condition of rupee in the economy
  - when RBI sells g-secs to banks
  - as soon as banks purchase g-secs, they have reduced money to lend to the industrial houses or other commercial sectors
  - this reduces surplus cash, contracts the rupee liquidity
  - contracts credit creation / credit supply

Cash Reserve Ratio

- It is the amount of funds that the banks are bound to keep with RBI as a percentage of their Net Demand and Time Liabilities (NDTL)
- **CRR = Cash Deposited with RBI / NDTL**
- **CRR has to be maintained on a daily basis with RBI by every bank**
- Objective
  - Ensure adequate liquidity in financial system
  - enough solvency for banks
  - CRR is maintained fortnightly average basis
- CRR is altered by RBI
- **RBI does not pay any interest on the CRR balances**
- Reduction of CRR
  - excess funds are available with banks for deploying in other businesses because they are required to keep lesser amounts with RBI
  - banks would have more money to lend
  - this leads to reduction of interest rates on loans provided by banks
  - example
    - SBI has balance of 100 crores
    - CRR @5%
    - SBI has to maintain atleast 5cr with RBI
    - Only has 95cr to its disposal
    - If CRR @4.5%
    - SBI can lend more now outside as it has 95.5cr to its disposal
  - Impact on inflation
    - Reduction in CRR leaves more money in the hands of commercial banks and this leads to increase in money supply in system
    - When money supply rises, too much money chases too few goods and this leads to rise in inflation
- Increase in CRR
  - banks will have less money
  - since banks don't earn any interest, banks are left with no option but to increase the interest rates
  - hike in CRR sucks money out of system causing inflation to come down
- **From 2006, RBI is empowered to fix the CRR on its discretion without any ceiling**

Statutory Liquidity Ratio

- All banks have to keep a fraction of their total net time and demand liabilites in form of liquid assets such as
  - G-secs
  - precious metals
  - approved securities amongst others
- Maintained with banks themselves
- **SLR = Liquid Assets / NDTL**
- **Ratio was prescribed by Section 24(2A) of Banking Regulation Act 1949**
- Original ratio mandated for a **23% SLR**
- **Presently 21% (August 2016)**
- SLR deposits include
  - Cash
  - Gold reserves kept in bank
  - Balances with RBI
  - Net balance in current account
  - Investment in G-secs(if any)
- **SLR has to be maintained on a daily basis by every bank**
- SLR is inversely proportional to money in market

CRR vs SLR

Key	CRR	SRR
Stored in form of	Cash	Liquid Assets
Stored With	RBI(in their premises)	Bank themselves
Ratio comparison	Less than SLR	More than CRR
Current Rates	4%	21.5%

Liquidity Adjustment Facility

- This is the primary instrument of RBI for modulating liquidity and sending interest rate signals to the market
- It refers to the difference b/w the two key rates
  - repo rate
  - reverse repo rate
- Also known as **Liquidity Corridor**
- While repo infuses liquidity into the system, reverse repo absorbs liquidity from system
- **RBI just announces Repo Rate**
- **Reverse repo rate is linked to repo rate and is 100 basis points (1%) below repo rate**

Marginal Standing Facility

- Created by **RBI in its credit policy of may 2011**
- MSF is the rate at which banks are able to borrow overnight funds from RBI against apporved government securities
- **MSF is always 1% higher than Repo rate**

Qualitative Tools

- Those tools thru which the central bank not only controls the value of loans but also the purpose for which these loans are assigned by the commercial banks
  - Moral suasion
  - Rationing of credit
  - Direct Action
  - Margin requirements

Moral Suasion

- Suasion means request or persuasion
- To arrest inflationary situation central bank persuades and requests the commercial banks to refrain from giving loans for speculative and non-essential purposes
- To counter deflation, central bank persuades the commercial banks to extend credit for different purposes
- Periodic discussions are held with authorities of commercial banks in this respect from 1949

Rationing of Credit

- Method by which the RBI seeks to limit the maximum amount of loans and advances
- Also in certain cases, fix ceiling for specific categories of loans and advances
- **Priority Sector Landing** - making credit flow to certain priority or weaker sectorsnby charging concessional rates of interest