

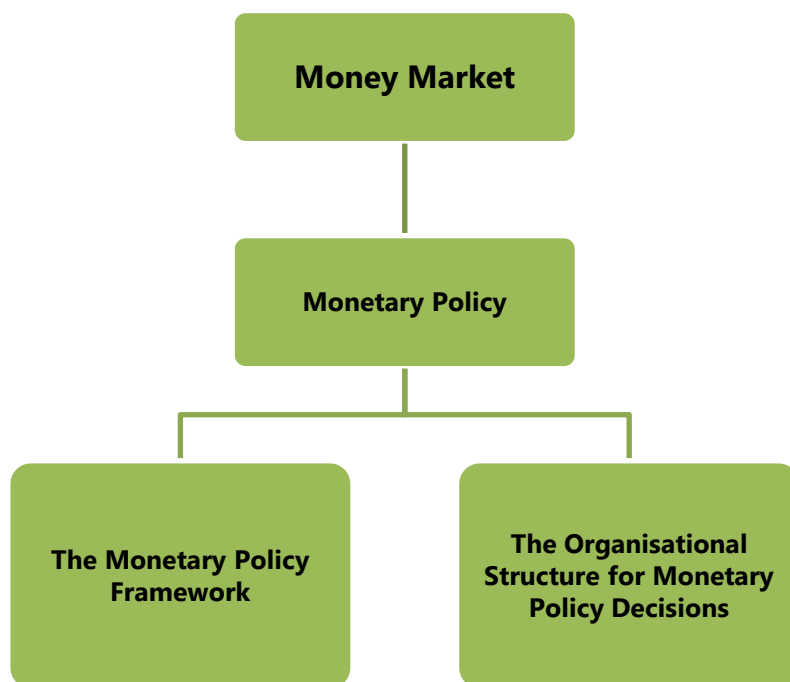
UNIT III: MONETARY POLICY

LEARNING OUTCOMES

At the end of 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

As citizens of a free nation, we have many dreams about what ought to be the state of affairs in our economy. We value stable prices and low rates of inflation. We share a quest for well-being through high levels of growth which ensure jobs and prosperity and we work towards it. Unfortunately, in reality, we live in a crisis prone economy with nightmares of financial downturns, of being laid-off or being battered by financial crises. We observe that the Reserve Bank of India is occasionally manipulating policy rates for maneuvering 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

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 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. In other words, monetary policy is essentially a programme of action undertaken by the monetary authorities, normally the central bank, to control and regulate the demand for and supply of money with the public and the flow of credit with a view to achieving predetermined macroeconomic goals. Monetary policy encompasses all actions of the central bank which are aimed at directly controlling the money supply and indirectly at regulating the demand for money. Monetary policy is in the nature of 'demand-side' macroeconomic policy and works by stimulating or discouraging investment and consumption spending on goods and services. It is no surprise that monetary policy is regarded as an indispensable policy instrument in an economy.

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 policy makers. 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. There are significant differences among different countries in respect of the selection of objectives, implementation procedures and tools of monetary policy either due to differences in the underlying economies or due to differences in the financial systems and in the infrastructure of financial markets. Coverage of aspects related to monetary policies of different countries would be beyond the scope of this unit. Therefore, the following discussions relate to the monetary policy situations in the context of Indian economy.

In the pre-Keynesian period, monetary policy, with its conventional objective of establishment and maintenance of stability in prices, was the single well-acknowledged instrument of macroeconomic policy. The Great Depression in 1930s and the associated economic crises marked a turning point resulting in a major shift in the objective of governments' economic policy in favour of maintenance of full employment, more generally described as economic stability. The most commonly pursued objectives of monetary policy of the central banks across the world are maintenance of price stability (or controlling inflation) and achievement of high level of economy's growth and maintenance of full employment

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'. It is to be noted that though price stability as an objective is not explicitly spelt out, the monetary policy in India has evolved towards maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. Price stability, as we know, is a necessary precondition for sustainable growth. Fundamentally, the primary objective of monetary policy has been maintenance of a judicious balance between price stability and economic growth.

Multiple objectives, all of which are equally desirable, such as rapid economic growth, debt management, moderate long-term interest rates, exchange rate stability and external balance of payments equilibrium were incorporated as objectives of monetary policy by policy makers in later years. The need for

simultaneous achievement of several objectives brings in the possibility of conflict among the different monetary policy objectives. For example, there is often a conflict between the objectives of holding down both inflation and unemployment; a policy targeted at controlling inflation is very likely to generate unemployment. As such, based on the set national priorities, the monetary policymakers have to exercise appropriate trade-offs to balance the conflicting objectives.

Given the development needs of developing countries, the monetary policy of such countries also incorporate 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 increasing openness of the economy and the progressive economic and financial sector reforms.

3.3.2 Analytics of Monetary Policy

As we are aware, just as fiscal policy, monetary policy is intended to influence macro- economic variables such as the aggregate demand, quantity of money and credit, interest rates etc, so as to influence overall economic performance. The process or channels through which the change of monetary aggregates affects the level of product and prices is known as 'monetary transmission mechanism'. It describes how policy-induced changes in the nominal money stock or in the short-term nominal interest rates impact real variables such as aggregate output and employment. 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.

There are mainly four different mechanisms through which monetary policy influences the price level and the national income. These are:

- (a) the interest rate channel,
- (b) the exchange rate channel,
- (c) the quantum channel (e.g., relating to money supply and credit), and
- (d) the asset price channel i.e. via equity and real estate prices.

We shall have a brief discussion on each of the above transmission mechanisms. According to the traditional Keynesian interest rate channel, a contractionary monetary policy-induced increase in interest rates increases the cost of capital and the real cost of borrowing for firms with the result that they cut back on their investment expenditures. Similarly, households facing higher real borrowing costs, cut back on their purchases of homes, automobiles, and all types of durable goods. A decline in aggregate demand results in a fall in aggregate output and employment. Conversely, an expansionary monetary policy induced decrease in interest rates will have the opposite effect through decreases in cost of capital for firms and cost of borrowing for households.

In open economies, additional real effects of a policy-induced change in the short-term interest rate come about through the exchange rate channel. Typically, the exchange rate channel works through expenditure switching between domestic and foreign goods. Appreciation of the domestic currency makes domestically produced goods more expensive compared to foreign-produced goods. This causes net exports to fall; correspondingly domestic output and employment also fall.

Two distinct credit channels- the bank lending channel and the balance sheet channel- also allow the effects of monetary policy actions to spread through the real economy. Credit channel operates by altering access of firms and households to bank credit. Most businesses and people mostly depend on bank for borrowing money. "An open market operation" that leads first to a contraction in the supply of bank reserves and then to a contraction in bank credit requires banks to cut back on their lending. This, in turn makes the firms that are especially dependent on banks loans to cut back on their investment spending. Thus, there is decline in the aggregate output and employment following a monetary contraction.

Now we shall look into how the balance sheet channel works. Logically, as a firm's cost of credit rises, the strength of its balance sheet deteriorates. A direct effect of monetary policy on the firm's balance sheet comes through an increase in interest rates leading to an increase in the payments that the firm must make to repay its floating rate debts. An indirect effect occurs when the same increase in interest rates works to reduce the capitalized value of the firm's long-lived assets. Hence, a policy-induced increase in the short-term interest rate not only acts immediately to depress spending through the traditional interest rate channel, it also acts, possibly with a time-lag, to raise each firm's cost of capital through the balance sheet channel. These together aggravate the decline in output and employment.

The standard asset price channel suggests that asset prices respond to monetary policy changes and consequently affect output, employment and inflation. A policy-induced increase in the short-term nominal interest rates makes debt instruments more attractive than equities in the eyes of investors leading to a fall in equity prices. If stock prices fall after a monetary tightening, it leads to reduction in household financial wealth, leading to fall in consumption, output, and employment.

The manner in which these different channels function in a given economy depends on:

- (i) the stage of development of the economy, and
- (ii) the underlying financial structure of the economy

3.3.3 Operating Procedures and Instruments

The operating framework relates to all aspects of implementation of monetary policy. It primarily involves three major aspects, namely,

- (i) choosing the operating target,
- (ii) choosing the intermediate target, and
- (iii) choosing the policy instruments.

The operating target refers to the variable (for e.g. inflation) that monetary policy can influence with its actions. The intermediate target (e.g. economic stability) is a variable which the central bank can hope to influence to a reasonable degree through the operating target and which displays a predictable and stable relationship with the goal variables. The 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.

The day-to-day implementation of monetary policy by central banks through various instruments is referred to as 'operating procedures'. For implementing monetary policy, a central bank can act directly, using its regulatory powers, or indirectly, using its influence on money market conditions as the issuer of reserve money (currency in circulation and deposit balances with the central bank).

In general, the direct instruments comprise of:

- (a) the required cash reserve ratios and liquidity reserve ratios prescribed from time to time.

- (b) directed credit which takes the form of prescribed targets for allocation of credit to preferred sectors (for e.g. Credit to priority sectors), and
- (c) administered interest rates wherein the deposit and lending rates are prescribed by the central bank.

The indirect instruments mainly consist of:

- (a) Repos
- (b) Open market operations
- (c) Standing facilities, and
- (d) Market-based discount window.

We shall now discuss in detail how these instruments are put to use for meeting the stated objectives of monetary policy.

1. Cash Reserve Ratio (CRR)

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. The RBI may set the ratio in keeping with the broad objective of maintaining monetary stability in the economy. This requirement applies uniformly to all scheduled banks in the country irrespective of its size or financial position. Non Bank Financial Institution (NBFIs) are outside the purview of this reserve requirement.

The Reserve Bank does not pay any interest on the CRR balances maintained by the scheduled commercial banks (SCBs) with effect from the fortnight beginning March 31, 2007; however, failure of a bank to meet its required reserve requirements would attract penalty in the form of penal interest charged by the RBI.

CRR has, in recent years, assumed significance as one of the important quantitative tools aiding in liquidity management. Higher the CRR with the RBI, lower will be the liquidity in the system and vice versa. During slowdown in the economy, the RBI reduces the CRR in order to enable the banks to expand credit and increases the supply of money available in the economy. In order to contain credit expansion during periods of high inflation, the RBI increases the CRR. The cash reserve ratio as on 8th July, 2017 was 4.0 per cent.

2. Statutory Liquidity Ratio (SLR)

The Statutory Liquidity Ratio (SLR) is a prudential measure. As per the Banking Regulations Act 1949, all scheduled commercial banks in India are required to

maintain a stipulated percentage of their total Demand and Time Liabilities (DTL) / Net DTL (NDTL) in one of the following forms:

- (i) Cash
- (ii) Gold, or
- (iii) Investments in un-encumbered Instruments that include:
 - (a) Treasury-bills of the Government of India.
 - (b) Dated securities including those issued by the Government of India from time to time under the market borrowings programme and the Market Stabilization Scheme (MSS).
 - (c) State Development Loans (SDLs) issued by State Governments under their market borrowings programme.
 - (d) Other instruments as notified by the RBI. These include mainly the securities issued by PSEs.

While CRR has to be maintained by banks as cash with the RBI, the SLR requires holding of assets in one of the above three categories by the bank itself. The banks which fail to meet its SLR obligations are liable to be imposed penalty in the form of a penal interest payable to RBI. As per the Second Bi-Monthly Monetary Policy Statement 2017-18 of the RBI on June 7th 2017, it has been decided to reduce the statutory Liquidity Ratio (SLR) from 20.5 percent to 20.0 per cent from June 24, 2017.

The SLR is also a powerful tool for controlling liquidity in the domestic market by means of manipulating bank credit. Changes in the SLR chiefly influence the availability of resources in the banking system for lending. A rise in the SLR which is resorted to during periods of high liquidity, tends to lock up a rising fraction of a bank's assets in the form of eligible instruments, and this reduces the credit creation capacity of banks. A reduction in the SLR during periods of economic downturn has the opposite effect. The SLR requirement also facilitates a captive market for government securities.

3. Liquidity Adjustment Facility(LAF)

A central bank is a 'bankers' bank.' It provides liquidity to banks when the latter face shortage of liquidity. This facility is provided by the Central Bank through its discount window. The scheduled commercial banks can borrow from the discount window against the collateral of securities like commercial bills, government securities, treasury bills, or other eligible papers. This type of support earlier took

the form of refinance of loans given by commercial banks to various sectors (e.g. Exports, agriculture etc). By varying the terms and conditions of refinance, the RBI could employ the sector-specific refinance facilities as an instrument of credit policy to encourage /discourage lending to particular sectors. In line with the financial sector reforms, the system of sector-specific refinance schemes (except export credit refinance scheme) was withdrawn. From June 2000, the RBI has introduced Liquidity Adjustment Facility (LAF).

The Liquidity Adjustment Facility(LAF) is a facility extended by the Reserve Bank of India to the scheduled commercial banks (excluding RRBs) and primary dealers to avail of liquidity in case of requirement (or park excess funds with the RBI in case of excess liquidity) on an overnight basis against the collateral of government securities including state government securities.

The introduction of LAF is an important landmark since it triggered a rapid transformation in the monetary policy operating environment in India. As a key element in the operating framework of the RBI, its objective is to assist banks to adjust their day to day mismatches in liquidity. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the Liquidity Adjustment Facility (LAF).

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 other words, repo is a money market instrument, which enables collateralised short term borrowing and lending through sale/purchase operations in debt instruments. The Repo transaction in India has two elements: - in the first, the seller sells securities and receives cash while the purchaser buys securities and parts with cash. In the second, the securities are repurchased by the original holder. The user pays to the counter party the amount originally received, plus the return on the money for the number of days for which the money was used, which is mutually agreed. All these transactions are reported on the electronic platform called the Negotiated Dealing System (NDS). The Clearing Corporation of India Ltd. (CCIL) has put in an anonymous online repo dealing system in India, with an anonymous order matching electronic platform. Repo or repurchase option is a collateralised lending. The rate charged by RBI for this transaction is called the 'repo rate'. Repo operations thus inject liquidity into the system.

The policy rate *

You might have read in business dailies about the 'policy rate'. 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. (It may be noted that India has many other repo rates in operation). The RBI uses the single independent 'policy rate' which is the repo rate (in the LAF window) for balancing liquidity. The policy rate is in fact, the key lending rate of the central bank in a country. A change in the policy rate gets transmitted through the money market to the entire the financial system and alters all other short term interest rates in the economy, thereby influencing aggregate demand – a key determinant of the level of inflation and economic growth. If the RBI wants to make it more expensive for banks to borrow money, it increases the repo rate. Similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate. In other words, an increase in the repo rate will lead to liquidity tightening and vice-versa, other things remaining constant.

As per the Second Bi-Monthly Monetary Policy Statement 2017-18 of the RBI on June 7th 2017, the Monetary Policy committee (MPC) has decided to keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.25 per cent, the reserve repo rate at 6.00 per cent and the Marginal Standing Facility (MSF) rate and the Bank rate at 6.50 per cent.

* Learners are requested to refer the RBI website (www.rbi.org.in) for up- to- date information on the prevailing policy rates.

'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 . Reverse repo operation takes place when RBI borrows money from banks by giving them securities. The securities transacted here can be either government securities or corporate securities or any other securities which the RBI permits for transaction. The interest rate paid by RBI for such transactions is called the 'reverse repo rate'. Reverse repo operation in effect absorbs the liquidity in the system. The collaterals used for repo and reverse repo operations consist of primarily Government of India securities i.e. all SLR-eligible transferable Government of India dated securities/treasury bills.

The 'repo rate' and the reverse repo rate' are changed only through the announcements made during the Monetary Policy Statements of the RBI. From May, 2011 onwards, the reverse repo rate is not announced separately, it will be

linked to repo rate. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

There are three types of repo markets operating in India namely:

- (i) Repo on sovereign securities
- (ii) Repo on corporate debt securities ,and
- (iii) Other Repos

In addition to the existing overnight LAF (repo and reverse repo) and MSF, from October 2013, the Reserve Bank has introduced 'Term Repo' (repos of duration more than a day) under the Liquidity Adjustment Facility (LAF) for 14 days and 7 days tenors. LAF is conducted at a fixed time on a daily basis on all working days in Mumbai (excluding Saturdays).

4. Marginal Standing Facility (MSF)

The Reserve Bank of India, being a bankers' bank, acts as a lender of last resort. The Marginal Standing Facility (MSF) announced by the Reserve Bank of India (RBI) in its Monetary Policy, 2011-12 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 (a fixed per cent of their net demand and time liabilities deposits (NDTL) *liable to change every year*) at a penal rate of interest. This provides a safety valve against unexpected liquidity shocks to the banking system. The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system.

Banks can borrow through MSF on all working days except Saturdays, between 7.00 pm and 7.30 pm, in Mumbai. The minimum amount which can be accessed through MSF is ₹ 1 crore and more will be available in multiples of ₹ 1 crore.

The MSF would be the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility on which the rates are lower compared to the MSF. The MSF rate being a penal rate automatically gets adjusted to a fixed per cent above the repo rate. MSF is at present aligned with the Bank rate. Practically, MSF represents the upper band of the interest corridor with repo rate at the middle and reverse repo at the lower band. In fact, the MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

5. Market Stabilisation Scheme (MSS)

This instrument for monetary management was introduced in 2004 following a MoU between the Reserve Bank of India (RBI) and the Government of India (Gol) with the primary aim of aiding the sterilization operations of the RBI. (Sterilization is the process by which the monetary authority sterilizes the effects of significant foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it). Under this scheme, the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows.

Bank Rate

Under Section 49 of the Reserve Bank of India Act, 1934, the Bank Rate has been defined as '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'. The bank rate once used to be the policy rate in India i.e. the key interest rate based on which all other short term interest rates moved. Discounting/rediscounting of bills of exchange by the Reserve Bank has been discontinued on introduction of Liquidity Adjustment Facility (LAF). As a result, the bank rate has become dormant as an instrument of monetary management. The bank rate has been aligned to the Marginal Standing Facility (MSF) rate and, therefore, as and when the MSF rate changes alongside policy repo rate changes, the bank rate also changes automatically. Briefly put, MSF assumed the role of bank rate and currently the bank rate is purely a signalling rate and most interest rates are delinked from the bank rate. Now, bank rate is used only for calculating penalty on default in the maintenance of Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

6. Open Market Operations

Open Market Operations (OMO) 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 durable basis. When the RBI feels there is excess liquidity in the market, it resorts to sale of securities thereby sucking out the rupee liquidity. Similarly, when the liquidity conditions are tight, the RBI will buy securities from the market, thereby releasing liquidity into the market.

3.4 THE ORGANISATIONAL STRUCTURE FOR MONETARY POLICY DECISIONS

We have discussed above the instruments of monetary policy. An understanding of the organisational structure for monetary policy decisions is necessary to understand the way monetary policy is conducted in India.

3.4.1 The Monetary Policy Framework Agreement

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 (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. Although in recent times many of the countries are moving away from this approach and the targeting nominal GDP growth.

3.4.2. The Monetary Policy Committee (MPC)

An important landmark in India's monetary history is the constitution of an empowered six-member Monetary Policy Committee (MPC) in September, 2016 consisting of the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three central government nominees representing the Government of India who are persons of ability, integrity and standing, having knowledge and experience in the field of Economics or banking or finance or monetary policy.

The MPC shall determine the policy rate required to achieve the inflation target. Accordingly, fixing of the benchmark policy interest rate (repo rate) is made through debate and majority vote by this panel of experts. With the introduction of the Monetary Policy Committee, the RBI will follow a system which is more consultative and participative similar to the one followed by many of the central banks in the world. The new system is intended to incorporate:

- diversity of views,
- specialized experience,
- independence of opinion ,
- representativeness , and
- accountability.

The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy. The views of key stakeholders in the economy and analytical work of the Reserve Bank contribute to the process for arriving at the decision on the policy repo rate.

The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations. The Financial Markets Committee (FMC) meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy (weighted average lending rate) is kept close to the policy repo rate.

Before the constitution of the MPC, a Technical Advisory Committee (TAC) on monetary policy with experts from Monetary Economics, Central Banking, Financial Markets and Public Finance advised the RBI on the standpoint of monetary policy. However, its role was only advisory in nature. With the formation of MPC, the TAC on Monetary Policy ceased to exist.

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 noncompetitive 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' ie 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 collateralised lending because banks borrow money from Reserve bank of India to fulfill 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

I 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 _____.
 - (e) reduce food shortages to achieve stability
 - (f) economic growth with price stability
 - (g) overall monetary stability in the banking system
 - (h) 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

II Short Answer Type Questions

1. Define monetary policy.
2. Describe the objectives of monetary policy?
3. What is meant by the term monetary policy framework?
4. Define 'monetary transmission mechanism'.
5. Explain the transmission of monetary policy outcomes through interest rate channel?
6. Distinguish between the bank lending channel and the balance sheet channel of monetary transmission?
7. How do asset prices respond to monetary policy?
8. What is meant by the term 'monetary policy instruments'?
9. What is the distinction between direct and indirect instruments of monetary policy?
10. Write notes on Cash Reserve Ratio (CRR) Explain the operation of CRR
11. Distinguish between CRR and Statutory Liquidity Ratio (SLR)
12. What are the eligible securities for SLR?
13. Explain the functioning of SLR?
14. What is the role of Liquidity Adjustment Facility (LAF)?
15. Define 'repo'

16. What is meant by 'policy rate'?
17. Define 'Reverse Repo'
18. What role does Market Stabilisation Scheme (MSS) play in our economy?
19. Assess the role of Bank Rate as an instrument of monetary policy
20. Open Market Operations
21. Outline the role of Monetary Policy Committee (MPC)

III Long Answer Type Questions

1. Explain the objectives of monetary policy in an economy. Assess the instruments and targets of monetary policy of the Reserve Bank of India.
2. Make a critical evaluation of the latest monetary policy statement of the Reserve Bank of India.
3. Explain the operational procedure of the monetary policy in India.
4. A central bank is a 'bankers' bank.' Elucidate the statement with illustrations
5. Describe the organisational structure for monetary policy decisions in India
6. Outline different components the monetary policy framework for India
7. Critically examine the different instruments of monetary policy.

IV Application Oriented Question

1. What will be the nature of the monetary policy undertaken by RBI in the following?
 - (i) Increases repo rate by 50 basis points
 - (ii) Reduces the cash reserve ratio
 - (iii) Increases the supply of currency and coins
 - (iv) Terminates marginal standing facility
 - (v) Increases the interest rates chargeable by commercial banks
 - (vi) Sells securities in the open market
 - (vii) Initiates reverse repo operation
 - (viii) Changes in the SLR

2. Write a brief note about the reasons why the policy rates were changed /not changed in the recent monetary policy announcement by the RBI

ANSWERS/HINTS

I Multiple Choice Type Questions

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)

II Short Answer Type Questions

1. Instruments which are at the disposal of the central bank to regulate the availability, cost and use of money and credit so as to attain predetermined objectives, mainly growth with stability
2. The most commonly pursued objectives of monetary policy: maintenance of price stability (or controlling inflation) and achievement of economic growth. Context-specific multiple objectives are pursued such as moderate long term interest rates, exchange rate stability and external balance of payments equilibrium etc.
3. The operating framework relates to all aspects of implementation of monetary policy
4. Different mechanisms through which monetary policy is able to influence the price level and the national income
5. A monetary policy-induced change in interest rates generate corresponding changes in the cost of capital and the real cost of borrowing for firms and households who respond by changing on their investment and purchase expenditures respectively affecting aggregate demand and employment.
6. Two distinct credit channels- the bank lending channel and the balance sheet channel- operate by altering access of firms and households to bank credit and by the effect of monetary policy on the firm's balance sheet respectively.
7. Asset prices generate important wealth effects that impact, through spending, output and employment.
8. 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.

9. Direct instruments presuppose one-to-one correspondence between the instrument (such as a credit ceiling) and the policy objective (such as a specific amount of domestic credit outstanding), while indirect instruments act through the market by adjusting the underlying demand for, and supply of, bank reserves
10. 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. Higher the CRR, lower the credit creation capacity of banks. Reduce CRR during deflation - banks to expand credit and increase the supply of money available in the economy - increase the CRR to contain credit expansion during - inflation.
11. While CRR has to be maintained by banks as cash with the RBI, the SLR requires holding of assets in one of the above three categories by the bank itself.
12. Cash, Gold, or investments in un-encumbered Instruments that include: treasury-bills, dated securities, State Development Loans (SDLs) issued by State Governments under their market borrowings programme and other instruments as notified by the RBI
13. Changes in SLR chiefly influence the availability of resources in the banking system for lending. A rise in SLR - during periods of high liquidity - to lock up a rising fraction of a bank's assets in the form of eligible instruments - reduces the credit creation capacity of banks. A reduction in SLR during periods of economic downturn has the opposite effect.
14. The Liquidity Adjustment Facility (LAF) is a facility extended by the Reserve Bank of India to the scheduled commercial banks (excluding RRBs) and primary dealers to avail of liquidity in case of requirement (or park excess funds with the RBI in case of excess liquidity) on an overnight basis against the collateral of government securities including state government securities.
15. 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'
16. The policy rate is the fixed repo rate quoted for sovereign securities in the overnight segment of Liquidity Adjustment Facility (LAF).
17. 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 .

18. 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 that are utilized for absorbing from the market excess liquidity of a more enduring nature arising from large capital inflows.
19. The bank rate has been aligned to the Marginal Standing Facility (MSF) rate and, therefore, as and when the MSF rate changes alongside policy repo rate changes, the bank rate also changes automatically. Now bank rate is used only for calculating penalty on default in the maintenance of Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).
20. Open Market Operations (OMO) 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 durable basis.
21. 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.

IV Hints to Application Oriented Questions

- (i) Contractionary monetary policy
- (ii) Expansionary monetary policy
- (iii) Expansionary monetary policy
- (iv) Contractionary monetary policy
- (v) Contractionary monetary policy
- (vi) Contractionary monetary policy
- (vii) Absorbs the liquidity in the system
- (viii) Influence the availability of resources in the banking system for lending