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DEPT. OF COMMERCE

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What is meant by Monetary Policy?

Monetary policy refers to the policy of the central bank – i.e., Reserve Bank of India – in matters of interest rates, money supply and availability of credit. It is through the monetary policy, RBI controls inflation in the country. RBI uses various monetary instruments like REPO rate, Reverse RERO rate, SLR, CRR etc to achieve its purpose.

In short, Monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.

Expansionary and Contractionary Monetary Policy:

We have already seen that monetary policy refers to the actions undertaken by a nation's central bank to control the money supply. Control of money supply helps to manage inflation or deflation. The monetary policy can be expansionary or contractionary.

An expansionary monetary policy is focused on expanding (increasing) the money supply in an economy. An expansionary monetary policy is implemented by **lowering key interest rates** thus increasing market liquidity.

A contractionary monetary policy is focused on contracting (decreasing) the money supply in an economy. A contractionary monetary policy is implemented by **increasing key interest rates** thus reducing market liquidity.

How does the Reserve Bank of India get its mandate to conduct monetary policy?

The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the Reserve Bank of India Act, 1934.

Recently there were many changes in the way Monetary Policy of India is formed – with the introduction of Monetary Policy Framework (MPF), Monetary Policy Committee (MPC), and Monetary Policy Process (MPP). We shall see each of these terms in detail soon.

What is the main goal of Monetary Policy of India?

Maintain price stability.

The primary objective of monetary policy is to maintain price stability while keeping in mind the objective of growth. Price stability is a necessary precondition for sustainable growth.

To maintain price stability, inflation needs to be controlled. The government of India sets an inflation target for every five years. RBI has an important role in the consultation process regarding inflation targeting. The current inflation-targeting framework in India is flexible in nature.

- **Flexible Inflation Targeting Framework:** Now there is a flexible inflation targeting framework in India (after the 2016 amendment to the Reserve Bank of India (RBI) Act, 1934).
- **Who sets the inflation target in India:** The amended RBI Act provides for the inflation target **to be set by the Government of India**, in **consultation with the Reserve Bank**, once every **five** years.
- **Current Inflation Target:** 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.
- **Factors that constitute a failure to achieve the inflation target:** (1) the average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters, OR (2) the average inflation is less than the lower tolerance level for any three consecutive quarters.

There are several direct and indirect instruments that are used for implementing monetary policy.

Quantitative Methods:

1. Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

2. Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.

3. Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of a range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market-based benchmarks for pricing of loans and deposits, and hence improve the transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

4. Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow an additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.

5. Bank Rate: It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers. The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934. This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF rate changes alongside policy repo rate changes.

6. Cash Reserve Ratio (CRR): The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such percentage of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.

7. Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.

8. Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

9. Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through the sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

Qualitative Methods:

Qualitative instruments are also known as selective instruments of the RBI's monetary policy. These instruments are used for discriminating between various uses of credit; for example, they can be used for favouring export over import or essential over non-essential credit supply. This method has an influence on both borrowers and lenders.

Following are some selective tools of credit control used by the RBI:

1. Rationing of Credit

RBI fixes a credit amount to be granted for commercial banks. Credit is given by limiting the amount available for each commercial bank. For certain purposes, the upper credit limit can be fixed, and banks have to stick to that limit. This helps in lowering the bank's credit exposure to unwanted sectors. This instrument also controls the bill rediscounting.

2. Regulation of Consumer Credit

In this instrument, consumers' credit supply is regulated through the instalment of sale and hire purchase of consumer goods. Here, features like instalment amount, down payment, loan duration, etc., are all fixed in advance, which helps to check the credit and inflation in the country.

3. Change in Marginal Requirement

Margin is referred to the certain proportion of the loan amount that is not offered or financed by the bank. Change in marginal can lead to change in the loan size. This instrument is used to encourage the credit supply for the necessary sectors and avoid it for the unnecessary sectors. That can be done by increasing the marginal of unnecessary sectors and reducing the marginal of other needy sectors.

Suppose, RBI feels that more credit supply should be allotted to the agricultural sector, then RBI will reduce the margin, and even 80-90% of the loan can be allotted.

4. Moral Suasion

Moral suasion refers to the suggestions to commercial banks from the RBI that helps in restraining credits in the inflationary period. RBI implies pressure on the Indian banking system without taking any strict action for compliance with rules.

Through monetary policy, commercial banks get informed of the expectations of RBI. The RBI can issue directives, guidelines, suggestions for commercial banks regarding reducing credit supply for speculative purposes under the moral suasion.