Monetary Policy of Reserve Bank Of India

Introduction

Monetary policy also known as the credit policy, is the policy which is purely managed by our Central bank of India (Reserve Bank of India) to control the money supply in the economy & amount of credit in the economy.

Monetary policy is governed by RBI . Monetary policy through both monetary and non-monetary measures influence savings , investment , output , income & price level in the economy.
To control the money supply RBI uses various instruments. Basically RBI control these rates like Bank Rates, MSF, Repo Rate, Reverse Repo rate, Cash Reserve ratio & Statutory liquidity ratio in order to manage price stability in the economy & to achieve high economic growth.

Objectives

The main aim of the monetary policy is Macro-Economic stability by maintaining price stability and adequate flow of credit to the productive sectors of the economy.
The Main important objectives of monetary policy are Price stability, Exchange Stability, Neutrality of Money, Economic Development, etc.

1. Price Stability

It is one of the most important objectives of the monetary policy. RBI makes efforts to control price stability through various monetary measures. Under price stability the fluctuations in prices are to controlled to have positive impact on production, income and employment generation in the economy. In absence of price stability, inflationary and deflationary conditions are generated in the economy, which affects the various sectors of the economy.

2. Exchange stability

It is one of the traditional objective of the monetary policy. Exchange rate stability means to minimise the rate of fluctuation in the value of a currency in respect to the value of another currency. Stability in exchange rate will lead to outflow of money and encourage development of international trade leading to favourable balance of payment situation.

3. Neutrality of Money

Neutrality of money means to keep the impact of charge in the quantity of money on various elements like price, income, employment as constant. Neutrality of money does not mean that the supply of money is perfectly inelastic and fixed but it means to control the effectiveness of money.

4. Economic development

In a developing economy monetary policy encourage economic development by attaining equilibrium between money supply and demand. Economic development and the capital formation are closely related and the monetary policy through its quantitative and qualitative measures accelerating saving , investment and capital formation for rapid economic growth.

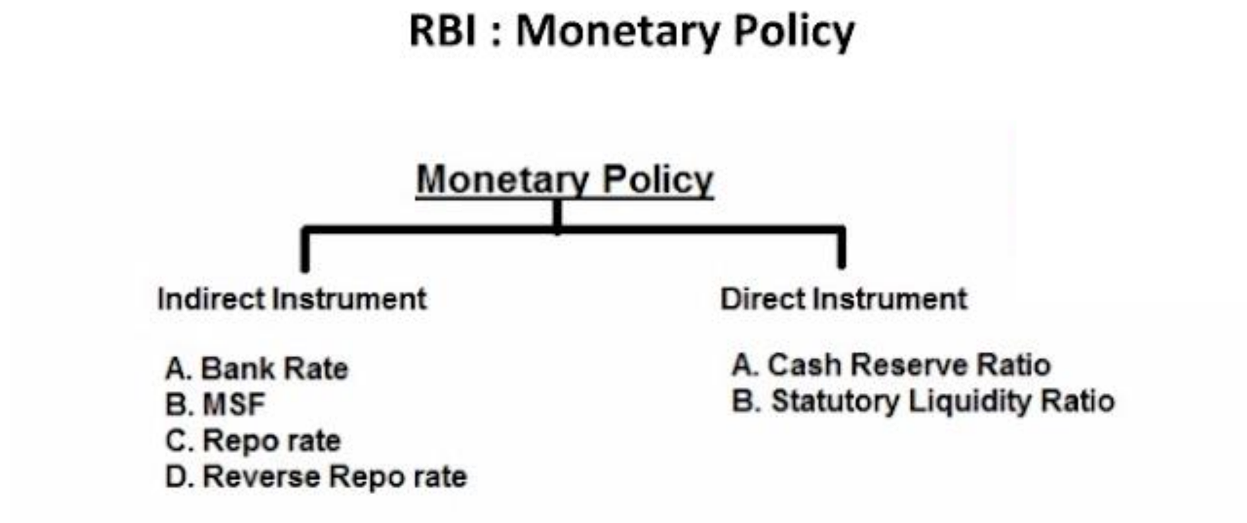
Measures of Monetary Policy

a. Quantitative Measures
b. Qualitative Measures

Roles of Monetary Policy

Monetary Policy cannot directly influence economic growth but it can prove a conductive environment that encourages growth through low and stable prices. When prices are stable people can effectively plan to invest, save and consume.When there are indications of excess supply of money and rising inflationary pressures the banks adopt the dear or restrictive monetary policy through the contraction of credit. On the other hand, when there is low money supply in the economy i.e. in the deflationary situation, bank through cheap or expansionary money policy increase the supply of money in order to stimulate domestic demand.

Instruments Of Monetary Policy



Direct Instruments

Cash Reserve Ratio

Every bank Maintain a certain % of their total deposits with RBI in the form of Cash and Net demand & Time liabilities. Current CRR is 4%. Every Bank has to pay the amount to RBI on every 15 Days.

Statutory Liquidity Ratio (SLR)

Every bank has to maintain a certain % of their total deposits in the form of (Gold + Cash + bonds + Securities) with themselves at the end of every business days. Current SLR is 20.75%.

Indirect Instruments

Bank Rate

Bank rate is also termed as “Discount Rate” The rate through which RBI charges certain % for providing money to other banks without any security for Long period of time for 90 Days & Current Bank Rate is 6.75%.

MSF (Marginal Standing Facility)

MSF is the rate through which bank can borrow funds for Short time – Overnight basis. Current MSF is 6.75%.

Repo Rate

Repo rate is the rate through which RBI lends money to commercial bank with security for Short period of time in the event of short fall of funds. Current Repo rate is 6.25%

Reverse Repo Rate

Reverse Repo rate is the rate through which Commercial Bank lends money to Central Bank of India i.e. RBI, for Short period of time. Current reverse repo rate is 5.75%

7 Monetary Policy Tools in hands of RBI

One of the major functions of RBI (Reserve bank of India) is to control inflation and liquidity in the economy. Today I am going to discuss various tools with RBI that directly impacts the money supply in the economy.

Cash Reserve Ratio

CRR is the minimum percentage of deposits with commercial banks that they need to deposit with the central bank of RBI.

Impact of increased CRR

Positive impact - It is a quick fix to control inflation. By increasing CRR, commercial banks need to deposit more money with RBI. Thus commercial banks left with less money. Now loans become dearer, so people have less money. As

Less money with Commercial banks → Less money with people → Lower demand for goods and services → Lower prices

Higher CRR simply sucks money from the economy.

Impact of decreased CRR

More money with Commercial banks → More money with people → Higher demand for good sand services → Higher prices

CRR should be aligned with supply and production levels. If people are producing more then they deserve to spend more. Decreased CRR provides a short term fix as it increases demand for short term.

Statutory liquidity ratio

This is the percentage of liabilities and time deposits that commercial banks need to keep with them in form of cash, gold or government approved securities.

Impact of increase in SLR

Commercial banks need to keep more liquid funds → Provides less loans to people → Lower demand for good sand services → Lower prices

Impact on decrease in SLR

Commercial banks need to keep less liquid funds → Provides more loans to people → Higher demand for good sand services → Higher prices

Repo and Reverse Repo rates

Repo rate

It is the rate at which RBI lends money to commercial banks against securities in case commercial banks fall short of funds.

Reverse Repo Rate

Rate at which RBI borrows money from commercial banks.

Impact

If commercial banks get more money they will lend more money to people which will lead more demand in economy. Thus prices will increase.

Bank rate

It is a rate at which RBI lends money to commercial banks **without any security**.

Impact

When bank rate is increased interest rate also increases which have negative impact on demand thus prices increases.

Marginal Standing Funding

By this mechanism commercial banks can get loans from RBI for their emergency needs. Commercial banks can take loan only upto 1% of their liabilities and time deposits.

Open market operations

Buying and selling government securities and bonds in order to manage liquidity in the economy.

Impact of purchasing securities

More money in economy → More demand → Higher growth rate

Impact of selling

Less money in economy → Less demand → Lower prices

> *Conclusion*

Many economist says effect of "More demand" is higher growth rate while some says higher prices. While it is actually state of economy. Money supply should be aligned with production rate.