[Academic Script]

[Design of Monetary Policy]

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Design of Monetary Policy

Introduction:

Hello friends, in this session we will discuss about the monetary policy, instruments of monetary policy, the way it is designed, the progresses in designing the monetary policies and the issues related to monetary policy.

Definitions of Monetary Policy:

Prof. Harry Johnson defines monetary policy "as policy employing central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy."

Prof. G.K. Shaw defines it as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money."

Monetary policy may either be defined in a broad or in a narrow sense:

Defined in a narrow sense, monetary policy comprises only those decisions and measures of the state and of the monetary authority which affect the volume of money and the level of interest rates. Thus, monetary policy is defined as comprising of such measures which lead to influencing the cost, volume and availability of money and credit so as to achieve certain set objectives.

In a broader sense, monetary policy not only includes monetary measures but also non-monetary measures which have monetary effects. In this sense, monetary policy covers a wide range of policies and measures. It includes not only monetary measures which influence the cost and availability of money but also those non-monetary measures which influence monetary situations.

Thus, non-monetary measures such as control of prices or wages, physical control, budgetary measures, income policy measures, etc. would be included within the scope of monetary policy defined in broader sense in so far as their primary aim is to influence the monetary situation.

In its broadest sense, monetary policy includes all actions of governments, central banks, and other public authorities that influence the quantity of money and bank credit.

Instruments of Monetary Policy:-

There are various instruments of monetary policy. Some are direct and some are indirect instruments.

- **Cash Reserve Ratio (CRR):** Cash reserve Ratio (CRR) is the amount of funds that the banks have to keep with the RBI. This is the percentage of a bank's total deposits that needs to be kept as cash with the RBI. The central bank can change the ratio to a limit. A high percentage means banks have less to lend, which curbs liquidity; a low CRR does the opposite. The RBI can reduce or raise CRR to tighten or ease liquidity as the situation demands.
- **Refinance Facilities:** RBI offers refinance facility to help out the exporters by replacing an existing debt obligation with another.
- **Statutory Liquidity Ratio (SLR):** SLR is the minimum proportion of cash, gold and securities which every bank maintains. This is the percentage of banks' total deposits that they are needed to invest in government approved securities. The lesser the amount of SLR, the more banks have to lend outside.

- **Bank Rate:** The rate of interest which the RBI charges on the loans and advances to a commercial bank. This is the re-discounting rate that RBI extends to banks against securities such as bills of exchange, commercial papers and any other approved securities. In recent years, it has been the repo rather than the bank rate that has acted as a guideline for banks to set their interest rates.
- **Liquidity Adjustments Facility (LAF):** It's a monetary policy tool which allows banks to borrow money through repurchase agreements and adjusting the day to day mismatches in liquidity.
- **Marginal Standing Facility (MSF):** It's a window for banks to borrow from the RBI in an emergency situation when inter-bank liquidity finishes completely.
- **Market Stabilization Scheme (MSS):** Securities that are issued with the objective of providing a stock of securities to the RBI to intervene in the market for managing liquidity.
- **Open Market Operations (OMO):** It's an activity by a RBI to give or take liquidity in its currency to or from a bank or a group of banks. This refers to buying and selling of government securities by RBI to regulate short-term money supply. If RBI wants to induce liquidity or more funds into the system, it will buy government securities and inject funds, and if it wants to curb the amount of money out there, it will sell these to banks, thereby reducing the amount of cash that banks have. RBI uses this tool actively even outside of its monetary policy review to manage liquidity on a regular basis.

- **Repo and Reverse Repo Rate**: Repo is a transaction where securities are sold by the RBI and simultaneously repurchased at a fixed price. This fixed price is determined in context to an interest rate called the repo rate. The transaction is relevant for banks; when they need funds from the RBI, the central bank repurchases the securities. The higher the repo rate, more costly are the funds for banks and hence, higher will be the rate that banks pass on to customers. A high rate signals that access to money is expensive for banks; lesser credit will flow into the system and that helps bring down liquidity in the economy. The reverse is the reverse repo rate, which banks use to park excess money with RBI.

Objectives of Monetary Policy:

According to RBI Governor Dr. D. Subba Rao, “The objectives of monetary policy in India are price stability and growth. These are pursued through ensuring credit availability with stability in the external value of rupee and overall financial stability.”

Following are the main objectives of monetary policy:

- **To Regulate Money Supply in the Economy:** Money supply includes both money in circulation and credit creation by banks. Monetary policy is framed to regulate the supply of money in the economy by credit expansion or credit contraction. Money supply can be expanded by credit expansion i.e. by giving more loans. And money supply can be decreased by credit contraction i.e. giving fewer loans.

- **To Attain Price Stability:** Another major objective of monetary policy in India is to maintain price stability in the country. It implies Control over inflation. Price level, is affected by money supply. Monetary policy regulates money supply to maintain price stability.
- **To promote Economic Growth:** An important objective of monetary policy is to make available necessary supply of money and credit for the economic growth of the country. Those sectors which are quite significant for the economic growth are provided with adequate availability of credit.
- **To Promote saving and Investment:** By regulating the rate of interest and checking inflation, monetary policy promotes saving and investment. Higher rates of interest promote saving and investment.
- **To Control Business Cycles:** Boom and recession are the main phases of business cycle. Monetary policy puts a check on boom and recession. In period of boom, credit is contracted, so as to reduce money supply and thus check inflation. In period of recession, credit is expanded, so as to increase money supply and thus promote aggregate demand in the economy.
- **To Promote Exports and Substitute Imports:** By providing concessional loans to export oriented and import substitution units, monetary policy encourages such industries and thus help to improve the position of balance of payments.
- **To Manage Aggregate Demand:** Monetary authority tries to keep the aggregate demand in balance with aggregate supply of goods and services. If aggregate demand is to be increased than credit is expanded and the interest rate is lowered

down. Because of low interest rate, more people take loan to buy goods and services and hence aggregate demand increases and vice-verse.

- **To ensure more Credit for Priority Sector:** Monetary policy aims at providing more funds to priority sector by lowering interest rates for these sectors. Priority sector includes agriculture, small- scale industry, weaker sections of society, etc.
- **To Promote Employment:** By providing concessional loans to productive sectors, small and medium entrepreneurs, special loan schemes for unemployed youth, monetary policy promotes employment.
- **To Develop Infrastructure:** Monetary policy aims at developing infrastructure. It provides concessional funds for developing infrastructure.
- **To Regulate and Expand Banking:** RBI regulates the banking system of the economy. RBI has expanded banking to all parts of the country. Through monetary policy, RBI issues directives to different banks for setting up rural branches for promoting agricultural credit. Besides it, government has also set up cooperative banks and regional rural banks. All this has expanded banking in all parts of the country.

Process of monetary policy formulation:

Monetary Policy Process:-

To formulate the monetary policy, the Reserve Bank's **Monetary Policy Department (MPD)** assists the Governor.

The main instrument Repo Rate is decided with the help of the following:

1.The views of key stakeholders in the economy

2.Advice of the Technical Advisory Committee (TAC)

3.Analytical work of the Reserve Bank

The Financial Markets Operations Department (FMOD) operationalizes the monetary policy with the help of day-to-day liquidity management operations.

The Financial Markets Committee (FMC) conducts daily meetings to review the consistency between policy rate, money market rates, and liquidity conditions.

RBI's 4th Bi-Monthly Policy Review

A **Monetary Policy Committee (MPC)** is there to help the government to frame policies. The amended RBI Act, 2016 provides a statutory basis for constitution of the MPC**.** The MPC has 6 members. The *Governor, one Deputy Governor and one officer of the Bank* would be the ex-officio members of the Committee. The other three members shall be appointed by the Central Government as per the procedure laid down in the amended RBI Act. The Committee determines the required policy interest rate to achieve the inflation target.

Monetary Policy Committee is defined in Section 2(iii) (cci) of the Reserve Bank of India Act, 1934 and is constituted under Sub-section (1) of Section 45ZB of the same Act.

The MPC replaces the current system where the RBI governor, with the aid and advice of his internal team and a technical advisory committee, has complete control over monetary policy decisions. A Committee-based approach will add lot of value and transparency to monetary policy decisions.

Recent Changes in RBI's Monetary Policy:

Since 1991 RBI's monetary management has undergone some major changes.

Let's discuss these changes one by one-

- **Multiple Indicator Approach**

Up to late 1990s, RBI used the 'Monetary targeting approach' to its monetary policy. Monetary targeting refers to a monetary policy strategy aimed at maintaining price stability by focusing on changes in growth of money supply. After 1991 reforms this approach became difficult to follow. So RBI adopted multiple indicator Approach in which it looks at a variety of economic indicators and monitor their impact on inflation and economic growth.

- **Selective Methods Being Phased Out**

With rapid progress in financial markets, the selective methods of credit control are being slowly phased out. Quantitative methods are becoming more important.

- **Reduction In Reserve Requirements**

In post-reform period the CRR and SLR have been progressively lowered. This has been done as a part of financial sector reforms. As a result, more bank funds have been released for lending. This has led to the growth of economy.

- **Deregulation Of Administered Interest Rate System**

Earlier lending rate of banks was determined by RBI. Since 1990s this system has changed and lending rates are determined by commercial banks on the basis of market forces.

- **Delinking Of Monetary Policy From Budget Deficit**

In1994 government phased out the use of adhoc treasury Bills. These bills were used by government to borrow from RBI to finance fiscal deficit. With phasing out of Bills, RBI would no longer lend to government to meet fiscal deficit.

- **Liquidity Adjustment Facility (LAF)**

LAF allows banks to borrow money through repurchase agreement LAF was introduced by RBI during June, 2000, in phases. The funds under LAF are used by banks to meet day-to-day mismatches in liquidity.

- **Provision of Micro Finance**

By linking the banking system with Self Help Groups, RBI has introduced the scheme of micro finance for rural poor. Along with NABARD, RBI is promoting various other microfinance institutions.

- **External Sector**

With globalisation large amount of foreign capital is attracted. To provide stability in financial markets, RBI uses sterilization and LAF to absorb the excess liquidity that comes in with huge inflow of foreign capital.

- **Expectation as a Channel Of Monetary Transmission**

Traditionally, there were four key channels of monetary policy transmission-Interest rate, credit availability, asset prices and exchange rate channels. Interest rate is the most dominant transmission channel as any change in monetary policy has immediate effect on it. In recent years fifth channel, Expectation has been added. Future expectations about asset prices, general price and Income levels influence the four traditional channels.

Lags in monetary policy:

The effectiveness of monetary policy as a countercyclical instrument depends heavily on the quickness of policy action and the quickness of response of the economy. Ideally, policy actions would be taken as soon as adverse developments appeared, or even in anticipation of such developments; and there would be an immediate and full response of aggregate demand and of such policy objectives as employment and output. Under such ideal conditions a high degree of stability might be maintained continuously. In practice, of course, such ideal performance is not realized.

Economists have long recognized three lags in monetary policy:

(1) the recognition lag—the interval between the time when a need for action develops and the time the need is recognized;

(2) The administrative lag—the interval between recognition and the actual policy action; and

(3) The operational lag—the interval between policy action and the time that the policy objectives, such as output and employment, respond fully.

Both the length and significance of these lags depend heavily on the reliability of economic forecasting. If developments could be reliably forecast well in advance, the first two lags could be eliminated and actions could be taken soon enough to allow for the operational lag.

But when economic forecasting is unreliable the monetary authority is likely to wait until a development appears before taking action to deal with it. In such cases the length of the operational lag becomes highly important for countercyclical policy. Those who favor flexible countercyclical monetary policies implicitly assume that the operational lag is rather short, that all or most of the effects of a monetary action will be achieved within a few months or a year.

This view has been challenged by some economists, notably by Milton Friedman. These economists contend that the responses to a given monetary action are distributed over time and that the full effects are realized only after a lag of considerably more than a year. Because of this, monetary actions taken to counter cyclical fluctuations may actually produce, or at least accentuate, these fluctuations. For example, expansionary policy actions taken to counter recession may have little effect for several months and then achieve their full expansionary effects on aggregate demand only when the economy is in its next boom phase. And actions taken to restrict aggregate demand during a boom may in fact precipitate and accentuate an ensuing depression.

For this and other reasons, members of this school oppose flexible countercyclical monetary policies. They believe that a greater degree of stability will be achieved by a monetary policy aimed at a steady growth of the money supply, regardless of cyclical conditions. This growth should be at an annual rate approximating the growth rate of real gross national product.

This whole question, which is obviously crucial for countercyclical monetary policy, remains unresolved and controversial. Friedman's theoretical and statistical arguments have been strongly challenged but not wholly refuted. Much more research is needed on both the magnitude and timing of responses to monetary policy actions. The same applies to the various types of fiscal policy actions.

Evaluation of Monetary Policy:

The RBI's aim at one time was controlled expansion. On one hand it was taking steps to expand bank credit. On other hand RBI uses quantitative and qualitative methods to control inflation. These two contradictory objectives limited the success of monetary policy. The performance of monetary policy can be seen from its achievements and failures, let us discuss.

Achievements:

Positive Aspects of Monetary Policy:-

- Short Term Liquidity Management:

RBI has developed various methods to maintain stability in interest rate and exchange rate like LAF, OMO and MSS. RBI has also managed its sterilization operations very well.

- Financial Stability :

With the help of controls, regulation and supervision mechanism, RBI has been successful in maintaining financial stability. During the period of global crisis it has also been able to maintain macroeconomic stability.

- Financial Inclusion:

Along with NABARD, RBI has made a great impact in the growth of microfinance. RBI has supported Self Help Group Model and promoted other microfinance institutions.

- Adaptability:

In India monetary policy is flexible, as it changes with time. RBI has developed new methods of credit control and shifted from monetary targeting to multiple indicator approach.

- Increase in Growth:

To maintain the growth of economy RBI has used its instruments' effectively. At present India is the fastest growing economy among the major countries. Thus monetary policy has played an important role in this area.

- Increase in Bank Deposits:

The increase in bank deposits over the years indicates trust and confidence of people in banking sector. Effective supervision of RBI over banks and financial institutions is largely responsible for trust and confidence of public in banking sector.

- Competition among Banks:

The monetary policy of RBI has resulted in healthy competition among banks in the country. The competition is due to deregulation of interest rates and other measures taken by RBI. Now-a-days due to professionalism banks provide better service to customers.

<u>Failures / Limitations of Monetary Policy</u>

- Huge Budgetary Deficits:

RBI makes every possible attempt to control inflation and to balance money supply in the market. However Central Government's huge budgetary deficits have made monetary policy ineffective. Huge budgetary deficits have resulted in excessive monetary growth.

- Coverage Of Only Commercial Banks :

Instruments of monetary policy cover only commercial banks so inflationary pressures caused by banking finance can be controlled by RBI, but in India, inflation also results from deficit financing and scarcity of goods on which RBI may not have any control.

- Problem Of Management Of Banks And Financial Institutions :

The monetary policy can succeed to control inflation and to bring overall development only when the management of banks and financial institutions are efficient and dedicated. Many officials of banks and financial institutions are corrupt and inefficient which leads to financial scams.

- Unorganised Money Market :

Presence of unorganised sector of money market is one of the main obstacles in effective working of the monetary policy. As RBI has no power over the unorganised sector of money market, its monetary policy becomes less effective.

- Less Accountability:

At present time, the goals of monetary policy in India are not set out in specific terms and there is insufficient freedom in the use of instruments. In such a setting, accountability tends to be weak as there is lack of clarity in the responsibility of governments and RBI.

- Black Money :

There is a growing presence of black money in the economy. Black money falls beyond the purview of banking control of RBI. It means large proposition of total money Supply in a country remains outside the purview of RBI's monetary management.

- Increased Volatility :

The integration of domestic and foreign exchange markets could lead to increased volatility in the domestic market as the impact of exogenous factors could be transmitted to domestic market. The widening of foreign exchange market and development of rupee - foreign exchange swap would reduce risks and volatility.

- Lack of Transparency:

According to S. S. Tarapore, the monetary policy formulation, in its present form in India, cannot be continued indefinitely. For a more effective policy, it would be necessary to have greater transparency in the policy formulation and transmission process and the RBI would need to be clearly demarcated.

Summary:

Thus, from above we can say that despite several problems RBI has made a good effort for effective implementation of the monetary policy in India. It uses various instruments to tighten or ease the flow of cash as per the circumstances. These instruments provide for the establishment of the economic stability in the country. The RBI uses the machinery to posit the Indian economy as a balanced economy and prevents it from being trapped in the bog of economic instability.