

# An Analysis on Monetary Policy tools and Money Supply in India

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This paper attempts to study how RBI through various instruments of **monetary policy** Apart from currency notes and coins, the balance in savings, or current account deposits, held by the public in commercial banks is also considered money since cheques drawn on these accounts are used to settle transactions. Such deposits are called demand deposits as they are payable by the bank on demand from the accountholder. Other deposits, e.g. fixed deposits, have a fixed period to maturity and are referred to as time deposits. Consider, for example, an individual who has a surplus of rice which she wishes to exchange for clothing. If she is not lucky enough she may not be able to find another person who has the diametrically opposite demand for rice with a surplus of clothing to offer in exchange. The search costs may become prohibitive as the number of individuals increases. Thus, to smoothen the transaction, an intermediate good is necessary which is acceptable to both parties. Such a good is called money. The individuals can then sell their produces for money and use this money to purchase the commodities they need. Though facilitation of exchanges is considered to be the principal role of money, it serves other purposes as well. Following are the main functions of money in a modern economy. Inquiry into the links between government borrowing and money supply boils down to a discourse on definitions and measures of money supply. Indian economists use the terms ‘money’, ‘money supply’ and ‘money stock’ synonymously.

*Key words: money supply, monetary liability, liquidity measure, RBI*

## Introduction

So Friedman and Mieselman argued that money should include time deposits. The above recommendation of FWG for compilation of a broader measure of money supply referred to as aggregate monetary resources was first implemented in 1964-65. The SWG renamed this measure ‘M3’. The SWG introduced two other sources of money stock called M2 and M4. The four measures of money supply for annual compilation developed in India by the SWG (1977) are as follows: M1 = currency with public + demand deposits with the banking system + other deposits with RBI M2 = M1 + saving deposits with post office savings banks M3 = M1 + time deposits with the banking system M4 = M1 + all deposits with post office savings banks excluding National Saving Certificates.

**Objective:**

This paper intends to explore and analyze importance of **Monetary policy** is an economic policy that manages the size and growth rate of the **money supply** in an economy. Also various mechanisms employed by RBI

**Monetary Policy tools and Money Supply in India:****Third Working Group: monetary aggregates**

They found that currency with public, demand and time deposits with banks and post office savings deposits were not perfect substitutes and further, in the early periods of the sample 1951-71 currency and in the latter period 1958-78 demand deposits received importance in the composition of money holdings. They concluded that components of monetary aggregates could not be same all the time, which researchers might surely have taken as a critique to current RBI practice. The Third Working Group (1998) The Third Working Group (1998) (TWG) proposed that money as a statistical construct reflected assets with monetary characteristics or specific liquid liabilities of a particular set of financial intermediaries and might not entail interest payments because money holders derived certain benefits, the opportunity cost of which was the interest. Narrow money perfectly satisfied transactions demand for money. The constituents of narrow money were limited to the central bank and the central government and depository corporations such as commercial and cooperative banks. The banking sector issued money. Banking sector in India comprised RBI, the State Bank of India and its subsidiaries, nationalized banks, regional rural banks, all other banks in private sectors including foreign banks, and Cooperative banks and any financial institution notified by government of India1 .

**Money per percentage change**

The TWG observed that except the United Kingdom no other country published the DI figures. As per the TWG in comparison between broader monetary aggregates and liquidity aggregates, the latter seemed to perform better. Bhole (1987) On the basis of the literature on definition and concept of money supply given above, Bhole (1987) distinguished between three approaches used for defining and measuring money supply: (a) Monetarist Empirical Approach (MEA) – as per this approach money was best measured as the sum of liquid financial assets which produces adequate theory of demand for money; (b) Substitution Approach (SA) – Under this approach the degree of substitutability between the traditionally defined monetary assets and other assets was ascertained by finding out cross elasticity of substitution, i.e. the percentage change in narrow money per percentage change in each competing asset and (c) Operational Approach (OA) – this approach emphasized on availability of data, frequency of availability of data etc. Bhole derived the following major conceptual differentia of money: general acceptability, perfect means of payment, perfect liquidity and maturity, net store of wealth or value, absence of rate of return and absence of being a part of

intended long term savings-investment portfolio. Following general consensus he excluded following ten assets from money supply - National Savings Certificates, Other certificates with post offices, Treasury Bills, Commercial Bills, Government Bonds, Industrial Bonds, fixed deposits (FD) with non-bank companies, Trade Credit, Unutilized credit limits, Industrial Shares.

At the same time he prescribed separate measures of near money assets on the basis of their liquidity, maturity, marketability, risk etc for those financial assets, which he excluded from money supply, because according to him the analysis of economic activity would be meaningless unless the role of the whole complex of other financial assets was considered and here he was in tune with the SWG. Empirically with help of multivariate regression analysis he explained that it was not wise for RBI to depend on narrow money multiplier, which they were doing in practice, for controlling money supply variations in India, because the regulation of government market borrowing, deficit financing, foreign exchange assets etc were important determinants of money supply. Jadhava (1988) and Jadhava (1994) Jadhava (1988) endorsed Bhole's proposition that conceptualization of the definition of money should precede the measure of money. Jadhava (1994) did not agree with the FWG's definition of money supply. He maintained that such definitions were unscientific because of absence of distinction between concept of money and measure of money.

In the then literature on concept of money supply there was a long-standing debate between two polar approaches for defining money: (i) a priori or theoretical approach and (ii) empirical approach. In the theoretical approach money was conceptualized first in terms of particular functional and institutional attributes and then the corresponding measure of money was constructed by aggregating relevant financial assets possessing particular attributes<sup>3</sup>. On the other hand the empirical approach did not rely on any preconceived notion of money. Between the two approaches theoretical approach had a greater analytical and scientific appeal. On the other hand the empirical approach defied this scientific sequence. Empirical approach confused empirical verification with hypothesization and therefore foreclosed the possibility of generating a testable hypothesis capable of empirical verification as a theory. Empirical approach is the antithesis of scientific procedure because monetary hypotheses, when embedded in definition of money by construction, preclude any empirical invalidation. For example, if money was defined as an aggregate of financial assets, which renders the maximum stability to money demand function, it is futile to test whether money demand function is stable or not. Such a definition of money implies taking stability of money demand for granted. Bhole blamed RBI for publishing data on multitude of money stock measures ranging from M1 to M4. In reply to this, Jadhava answered that empirical substitution approach aimed not at deciding which assets could be regarded.

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).

## 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 to 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 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 in every **five** years.
- **Current Inflation Target:** The Central Government has notified **4 percent Consumer Price Index (CPI) inflation as the target** for the period from August 5, 2016, to March 31, 2017, with the upper tolerance limit of 6 percent and the lower tolerance limit of 2 percent.
- **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.

## The Monetary Policy Framework (MPF)

While the Government of India sets the Flexible Inflation Targeting Framework in India, it is the **Reserve Bank of India (RBI) which operates the Monetary Policy Framework of the country.**

- The amended RBI Act explicitly provides the legislative mandate to the Reserve Bank to operate the monetary policy framework of the country.
- The framework aims at **setting the policy (repo) rate** based on an assessment of the current and evolving macroeconomic situation, and **modulation of liquidity conditions to anchor money market rates at or around the repo rate.**
- Note: Repo rate changes transmit through the money market to the entire the financial system, which, in turn, influences aggregate demand – a key determinant of inflation and growth.
- Once the repo rate is announced, the operating framework designed by the Reserve Bank envisages liquidity management on a day-to-day basis through appropriate actions, which aim at anchoring the operating target – the weighted average call rate (WACR) – around the repo rate.



## Monetary Policy Committee (MPC)

Now in India, the policy interest rate required to achieve the inflation target is decided by the Monetary Policy Committee (MPC). MPC is a six-member committee constituted by the Central Government (Section 45ZB of the amended RBI Act, 1934).

The MPC is required to meet **at least four times in a year**. The quorum for the meeting of the MPC is four members. Each member of the MPC has one vote, and in the event of an equality of votes, the Governor has a second or casting vote.

**The resolution** adopted by the MPC is published after the conclusion of every meeting of the MPC. Once in every six months, the Reserve Bank is required to publish a document called the **Monetary Policy Report** to explain: (1) the sources of inflation and (2) the forecast of inflation for 6-18 months ahead.

## The present Monetary Policy Committee (MPC)

The Central Government in September 2016 constituted the present MPC as under:

1. Governor of the Reserve Bank of India – Chairperson, *ex officio*;
2. Deputy Governor of the Reserve Bank of India, in charge of Monetary Policy – Member, *ex officio*;
3. One officer of the Reserve Bank of India to be nominated by the Central Board – Member, *ex officio*;
4. Shri Chetan Ghate, Professor, Indian Statistical Institute (ISI) – Member;
5. Professor Pami Dua, Director, Delhi School of Economics – Member; and
6. Dr. Ravindra H. Dholakia, Professor, Indian Institute of Management, Ahmedabad – Member. (Members referred to at 4 to 6 above, will hold office for a period of four years or until further orders, whichever is earlier.

## The Monetary Policy Process (MPP)

**The Monetary Policy Committee (MPC)** determines the policy interest rate required to achieve the inflation target.

**The Reserve Bank's Monetary Policy Department (MPD)** assists the MPC in formulating the monetary policy. 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 Market 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. This parameter is also known as weighted average call money rate (WACR).

### **Monetary Policy Instruments (MPI)**

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

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 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 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. **Corridor:** The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.
6. **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.
7. **Cash Reserve Ratio (CRR):** The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such percent of its Net demand and time liabilities (NDTL) that the Reserve Bank may notify from time to time in the Gazette of India.
8. **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.

9. **Open Market Operations (OMOs):** These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.
10. **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.

## Conclusion

In a modern economy, money comprises cash and bank deposits. Depending on what types of bank deposits are being included, there are many measures of money. Central Bank is a very important institution in a modern economy. Almost every country has one central bank. India got its central bank in 1935. Its name is the 'Reserve Bank of India'. Central bank has several important functions. It issues the currency of the country. It controls money supply of the country through various methods, like bank rate, open market operations and variations in reserve ratios. It acts as a banker to the government. It is the custodian of the foreign exchange reserves of the economy. It also acts as a bank to the banking system. These are created by a system comprising two types of institutions: central bank of the economy and the commercial banking system. 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**.

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