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Empirical Study on Monetary Policy Tools in the Hands of the Reserve Bank of India

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Abstract

This paper attempts to study how **monetary policy can be employed in an incomplete monetary union**. 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. The operating framework is fine-tuned and revised depending on the evolving financial market and monetary conditions, while ensuring consistency with the monetary policy stance. The repo rate changes spread through the money market to the entire financial system, influencing the aggregate demand – a key factor of inflation and growth. Once the repo rate is declared, the operating structure designed by RBI predicts liquidity management on a daily basis through suitable actions, aiming to anchor the weighted average call rate (WACR) around the repo rate. The operating framework is modified and reviewed depending on the growing financial market and economic conditions, while ensuring uniformity with the financial policy stance. The liquidity management framework was revised significantly in April 2016.

Key words: Monetary policy*, RBI, Fiscal policy, repo rate, interest rates, exchange rates,*

Introduction

Monetary policy is the process by which the monetary authority of a country, generally the central bank, controls the supply of money in the economy by its control over interest rates in order to maintain price stability and achieve high economic growth. In India, the central monetary authority is the Reserve Bank of India (RBI). It is designed to maintain the price stability in the economy. Other objectives of the monetary policy of India, as stated by RBI, are:

Objective:

This paper intends to explore and analyze **Monetary policy** involves influencing interest rates and exchange rates to benefit a country's economy. Which is done by a central bank (RBI) controlling the supply of currency

What are the monetary policy tools in the hands of the Reserve Bank of India?

The monetary policy framework aims to set the policy repo rate as per the assessment of the present and developing macroeconomic situation. The agenda also aims at modulating liquidity conditions to adjust the money market rates at/around the repo rates.

In order to control the monetary system, the Reserve Bank of India uses seven different tools. These tools are used to mitigate inflations. In this regard, it is to mention that the Reserve Bank of India controls inflation by controlling the liquid cash in the market and this is done through the following tools:

1. Cash Reserve Ratio (CRR)

Every commercial bank in India is required to deposit a small proportion of its total deposit with the Reserve Bank of India. This proportion or percentage of the total deposit that the commercial banks deposit with the RBI is called the Cash Reserve Ratio.

Importance of Cash Reserve Ratio:

If the RBI increases the CRR, the liquid cash in the hands of commercial banks decreases. Thus, the commercial banks' lending capacity falls with the rise of the CRR. When the economy faces the problem of inflation, the Reserve Bank of India increases the Cash Reserve Ratio for lowering the lending capacity of the commercial banks. Similarly, when the economy faces a lack of liquid cash, the RBI uses this tool to combat deflation. RBI decreases the CRR to help the commercial banks to lend more money to the public. Therefore, this monetary policy tool has effective outcomes over the economy and due to this reason, RBI uses this tool to control the monetary system of the country.

2. Statutory Liquidity Ratio (SLR):

Every commercial bank utilises the deposits by investing them in profitable investment options including giving a loan to the public. However, the commercial banks are required to deposit a small portion of the total deposit with the RBI as CRR and another portion as liquid cash in hand. The portion of cash that the commercial banks keep with them in form of cash is called the liquidity ratio. This liquid money is used for meeting the demand of the depositors. Being the regulator of scheduled banks, the RBI mandates the liquidity ratio, which is required to be maintained by all commercial banks. This ratio is called the Statutory Liquidity Ratio (SLR).

Importance of SLR:

If the RBI enhances the SLR, the commercial banks need to keep a higher amount of money in their hands. This means the lending capacity of the banks will fall with the rise in SLR. This will result in fall in liquid cash in the hands of the public. As a consequence of this, the demand for goods or services will fall and therefore there will be a fall in the price of

commodities in the market. However, the RBI can use this tool in case of slow economic growth. The RBI decreases the SLR to enhance the lending capacity of the commercial banks, and by this, the RBI can combat against low production and demand.

3. Bank Rate:

Reserve Bank of India lends money to commercial banks in two different ways. The advance can be made with or without any security. If the RBI lends money to commercial banks without any security, then the rate at which the loan is allowed to the commercial banks is called the Bank Rate.

Importance of Bank Rate:

If the bank rate rises, the cost of taking a short-term loan from the RBI becomes high, which affects the advancing ability of the commercial banks. On the other hand, a fall in the bank rate facilitates the commercial banks to take the loan from the RBI at a lower rate.

4. Repo Rate:

In case of any deficit, commercial banks take a short-term loan from the Reserve Bank of India against some securities. The interest rate charged by the RBI is called the Repo Rate.

Importance of Repo Rate:

The rise in the Repo Rate implies an enhancement in the cost of short-term debt for the commercial banks. Therefore, RBI can mitigate the short-term demand for money by increasing the Repo Rate.

5. Reverse Repo Rate

From the name, it is clear that this is just the reverse of the Repo. This rate is charged by the commercial banks for lending Reserve Bank of India. However, the Reverse Repo Rate is determined by the Central Bank of the country (RBI).

Importance of the Reverse Repo Rate:

If there is a surplus of the fund in the hands of commercial banks, they can be able to lend more money to the people. This enhances the purchasing power of the people of the country. In this context, if the RBI offers a higher rate for lending funds from the commercial banks, the commercial banks' ability to give a loan to the public decreases. By this way, the RBI can control the lending power of the commercial banks.

6. Open Market Operations:

The open market operation is to be considered as one of the most crucial roles that the Reserve Bank of India plays in the Indian economy. The Reserve Bank of India buys and sells government securities. The primary objective of the open market operation is to manage the liquidity in the market.

Importance of the Open Market Operations:

When the RBI buys security from the open market, the liquid market in the economy rises. This results in an enhancement in the aggregate demand in the economy. Thus, the purchase of the security from open market results in a price hike. However, the RBI use this tool for attaining higher growth rate.

7. Marginal Standing Funding:

In case of an emergency, commercial banks can apply for funding to the RBI. Due to this service of the RBI, it is called the *lender of last resort*. In this regard, it is to be noted that the commercial banks can get up to 1% of the total deposit

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 of 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 the weighted average call money rate (WACR).

Conclusion

It is clear that the RBI has seven weapons to control the monetary policy. In this context, it is to be noted that the increase in liquid money helps in growth in the economy. The resurgence of Covid-19 pandemic in India in the recent weeks and the consequent containment measures to check the spread of the pandemic may impact the recovery process and create new uncertainties. With the objective of alleviating the potential stress to individual borrowers and small businesses, the following set of measures are being announced. However, the inflation factor is to be considered as another outcome of such higher liquidity. Thus, the RBI is required to maintain the balance between the growth and inflation while setting monetary policy. Monetary policy refers to the policy of the central bank – ie Reserve Bank of India – in matters of interest rates, money supply and availability of credit. 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. 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. (This is explained well in one of our earlier articles – basics of economy concepts). 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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