Monetary Policy

- It is the policy under which RBI uses monetary instruments (interest rate and other instruments) under the RBI Act, 1934, to influence money supply in the economy to achieve certain macroeconomic goals.
- The Monetary Policy Committee (MPC) is a committee appointed by the Central Government and chaired by the Governor of the Reserve Bank of India.
- The Monetary Policy Committee was established with the mission of determining the benchmark policy interest rate (repo rate) in order to keep inflation within a specific target level.
- The RBI governor makes monetary policy decisions with the help of an internal team and a technical advisory committee.
- The Monetary Policy Committee is a statutory body established under section 45ZB of the Reserve Bank of India Act 1934.
- It is an institutionalized framework for maintaining price stability while pursuing the goal of growth.
- It is set up based on the recommendation of the Urjit Patel Committee.

Composition of Monetary Policy Committee

- **Chairman:** The Governor of the Reserve Bank of India serves as the committee's ex-officio Chairman.
- **Members:** The committee consists of six members (including the Chairman): three RBI officials and three government-nominated external members.

The RBI officials are:

- Governor of the Reserve Bank of India
- Deputy Governor of the Reserve Bank of India, in charge of Monetary Policy – Member, ex officio;
- One officer of the Reserve Bank of India to be nominated by the Central Board – Member, ex officio;

Objectives:

- Accelerating economic growth.
- Price stability

- Exchange rate stabilization
- Balancing savings and investment.
- Employment generation.

Quantitative Tools:

- These tools help in channelizing the volume of credit towards the economy.
- The aim is to control the economic indicators like inflation, money circulation etc.

Bank Rate

- Minimum rate at which the RBI provides loan to commercial banks.

Repo Rate

- Rate at which the RBI lends to the commercial banks to manage short term needs of liquidity with an agreement to repurchase the same government securities at a predetermined date and rate is called Repo Rate.

Reverse Repo Rate

- 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.
- It is lower than repo rate.

Long Term Repo Operations (LTRO)

- It is a tool under which the RBI provides 1–3-year money to banks at the prevailing repo rate, accepting government securities with matching or higher tenure as the collateral.
- LTRO scheme will be in addition to the existing Liquidity Adjustment Facility (LAF) and the Marginal Standing Facility (MSF) operations
- Cash Reserve Ratio (CRR) is decided by RBI's Monetary Policy Committee.
- Banks are required to maintain with the Reserve Banka certain percent of its Net Demand and Time Liabilities (NDTL) as specified by RBI.
- Banks do not get any interest on the money that is with the RBI under the CRR requirements.

Liquidity Adjustment Facility (LAF)

- LAF allows commercial banks and primary dealers to borrow money through repurchasing agreements or repos/reverse repos.
- It is used to aid banks in adjusting the daily fluctuations in liquidity.
- It allows banks to park their excess money with the RBI in case of excess liquidity or to avail liquidity from the RBI at the time of deficit on an overnight basis against the collateral of government securities.

Open Market Operations (OMO)

- It is the purchase and sale of securities by the RBI.

Marginal Standing Facility (MSF)

- It is a penal rate at which scheduled banks can borrow money from the RBI over and above what they can borrow from the RBI under the LAF window.
- It is always fixed at a higher rate than the Repo rate.
- Aims to reduce volatility in the overnight lending rates in the interbank market.

Cash Reserve Ratio (CRR)

- The Cash Reserve Ratio (CRR) is the minimum percentage of total deposits (i.e. NDTL) that a commercial bank is required to retain as cash reserves with the RBI.
- It has to be in the form of Cash.
- It is applicable to all Scheduled commercial banks.
- For Instance, let us consider that bank a has received 100 Crores as Deposits.
- If we have a CRR of 3% then bank a has to deposit 3 crores in Cash form with the RBI and is left with 97 crores for its operation.
- When a central bank raises the CRR, the amount of money accessible to banks reduces or falls and vice-versa.
- It has to be placed in a vault in the bank or placed with the RBI.

Statutory Liquidity Ratio (SLR)

- Statutory Liquidity Ratio (SLR) is the minimum percentage of deposits (i.e. Net Demand and Time Liabilities (NDTL)) that a commercial bank must keep with itself.

This asset can be in the form of the following:

- Cash
- Gold valued at a price not exceeding the current price
- Government securities and Treasury Bills
- **Note:** In the case of securities, the bank can only hold government securities and cannot invest in any private stocks.
- The Reserve Bank of India is authorized to set SLR and change it with changing macroeconomic conditions.
- To keep bank credit under control, the Reserve Bank of India raises the SLR as inflation rises.
- During a recession, the RBI lowers the SLR to promote bank credit.
- The CRR (Cash Reserve Ratio) and SLR (Stock Liquidity Ratio) have long been used by central banks to limit credit growth, liquidity flow, and inflation in the economy.

Qualitative Tools

- These measures help in controlling the distribution and direction of the loans to different sectors of the economy.

Margin Requirements

- Difference between the current value of the security offered for a loan (called collateral) and the value of loan granted.
- Higher the Margin, Lesser will be the loan granted.
- **Example,** If the RBI feels that more credit should be allocated to priority sectors, then it will reduce the margin.

Credit Rationing

- The Central Bank fixes a limit on the credit amount to be granted by each commercial bank.
- Helps in lowering banks credit exposure to unwanted sectors.

Moral Suasion

- Issue Directives, meetings, Persuasion and pressure, Inspections and frequent follow ups.

Direct Action

- Impose fines, ban non-cooperating banks, refuse rediscounting of their bills, refuse credit supply

Unconventional Monetary Policy Tools

Zero Interest Rate Policy (ZIRP)

- A zero-interest rate policy (ZIRP) is when a central bank sets its target short-term interest rate at or close to 0%.
- The goal is to spur economic activity by encouraging low-cost borrowing and greater access to cheap credit by firms and individuals.
- Because nominal interest rates are bound by zero, some economists warn that a ZIRP can have negative consequences such as creating a liquidity trap.

Negative Interest Rate Policy (NIRP)

- A negative interest rate policy (NIRP) occurs when a central bank sets its target nominal interest rate at less than zero percent.
- This extraordinary monetary policy tool is used to strongly encourage borrowing, spending, and investment rather than hoarding cash, which will lose value to negative deposit rates.

Helicopter Money

- American economist Milton Friedman coined this term.
- It is an unconventional monetary policy tool aimed at bringing a flagging economy back on track.
- It injects cash into an economy as if it was thrown out of a helicopter.
- Helicopter money refers to increasing a nation's money supply through more spending, tax cuts, or boosting money supply.
- Some of the stimulus measures taken by different federal banks in response to the Covid-19 crisis resemble the concept of helicopter drop money.

Monetary Policy Stances

Accommodative Stance

- It means RBI may reduce the policy rates to increase the money supply in the economy.
- Policy rates normally decrease.

- This policy is adopted when there is a slowdown in the economy.

Neutral Stance

- It means RBI would have the flexibility to either increase or decrease the policy rates by taking into account the macro-economic conditions.
- Policy rates would move in either direction.
- This policy is adopted when the inflation rate is stable.

Calibrated Tightening

- It means the RBI would either keep the rates constant or increase the rates.
- Policy rates either remain unchanged or increase. No decrease.
- This policy is adopted when there are concerns of a higher rate of inflation.