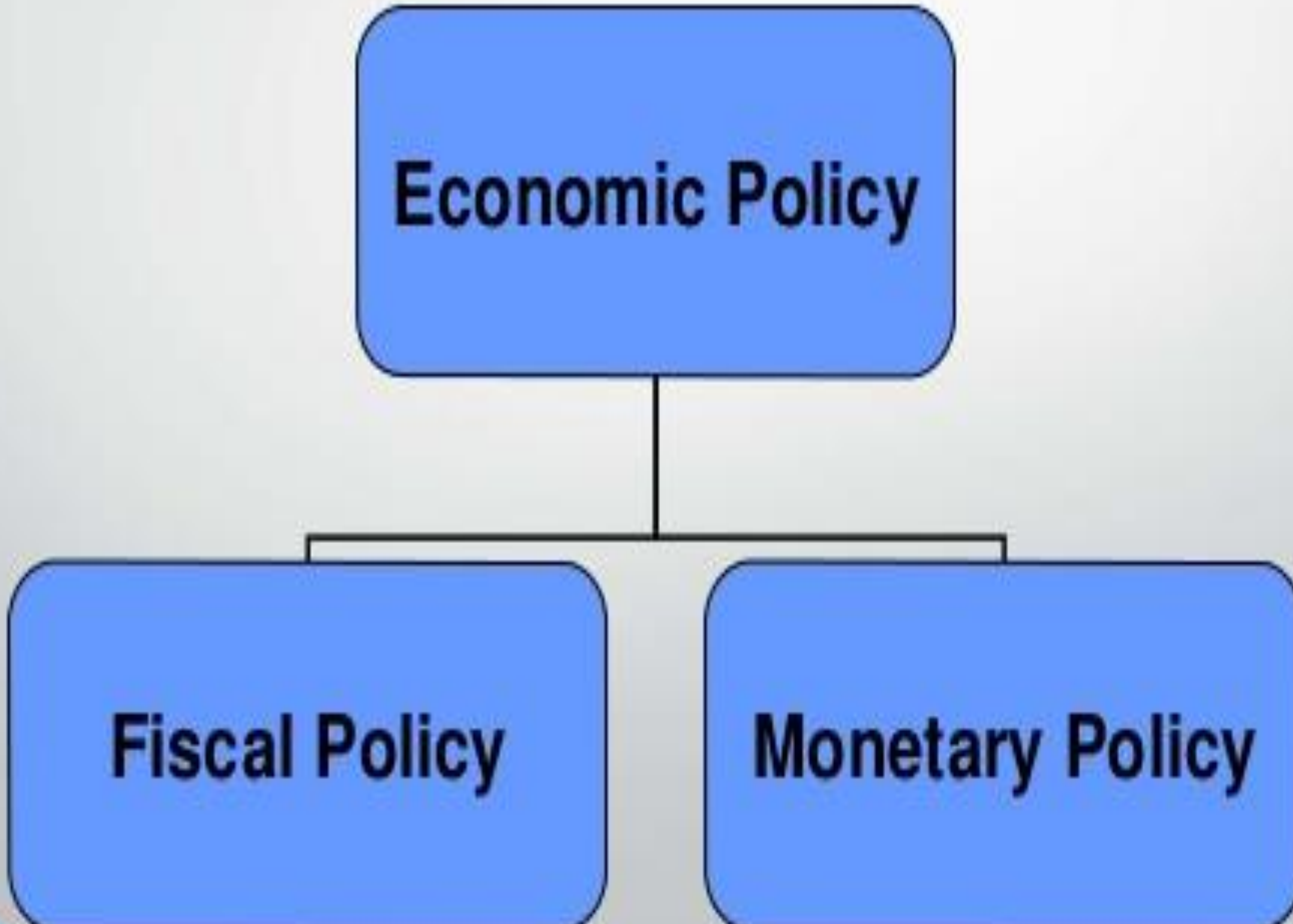
Monetary Policies of RBI

Economic policies for Stabilization



Definition:

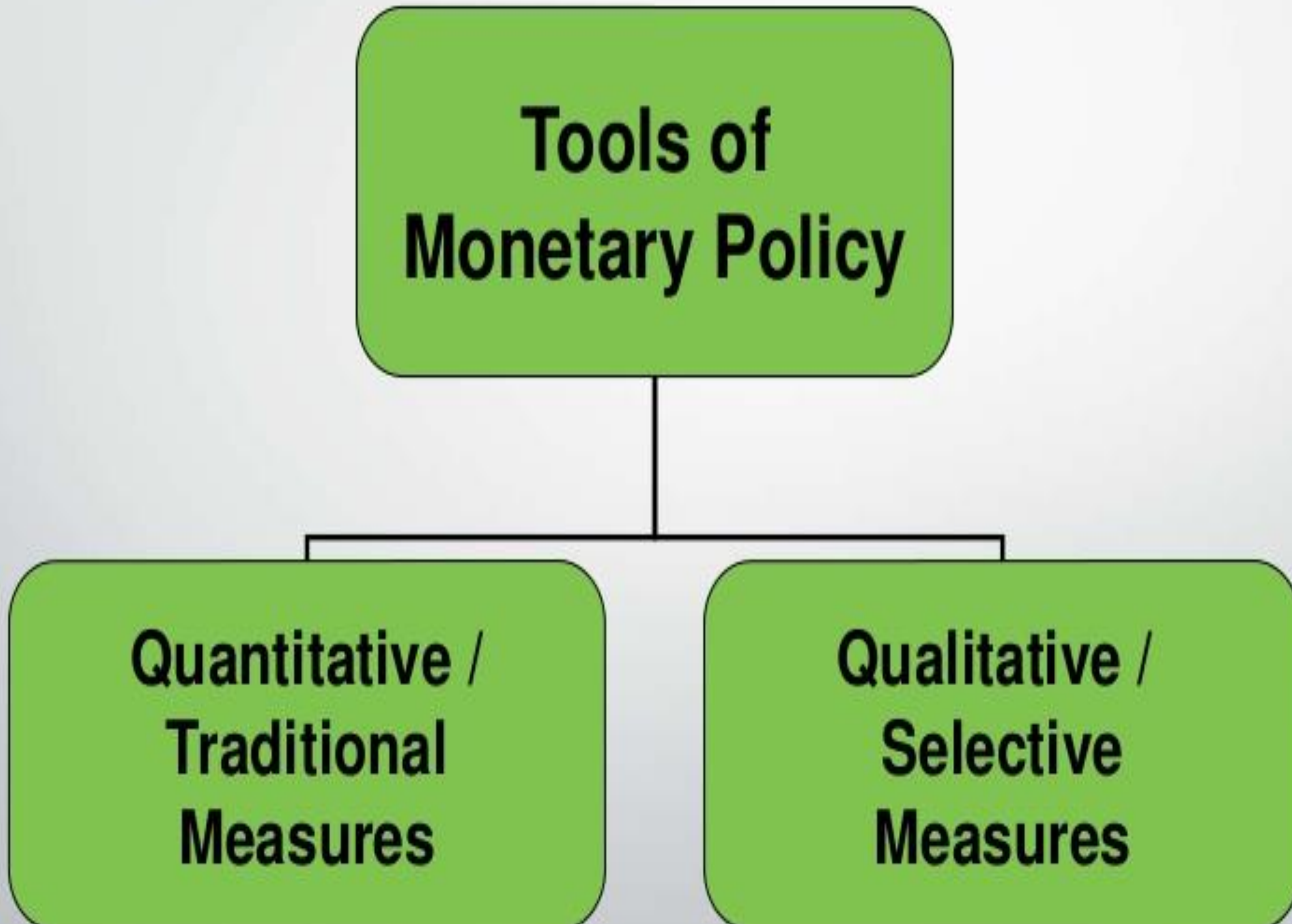
- The part of the economic policy which regulates the level of money in the economy in order to achieve certain objectives
- In INDIA,RBI controls the monetary policy. It is announced twice a year, through which RBI , regulate the price stability for the economy.

1.slack season policy	April-September
2.Busy season policy	October-March

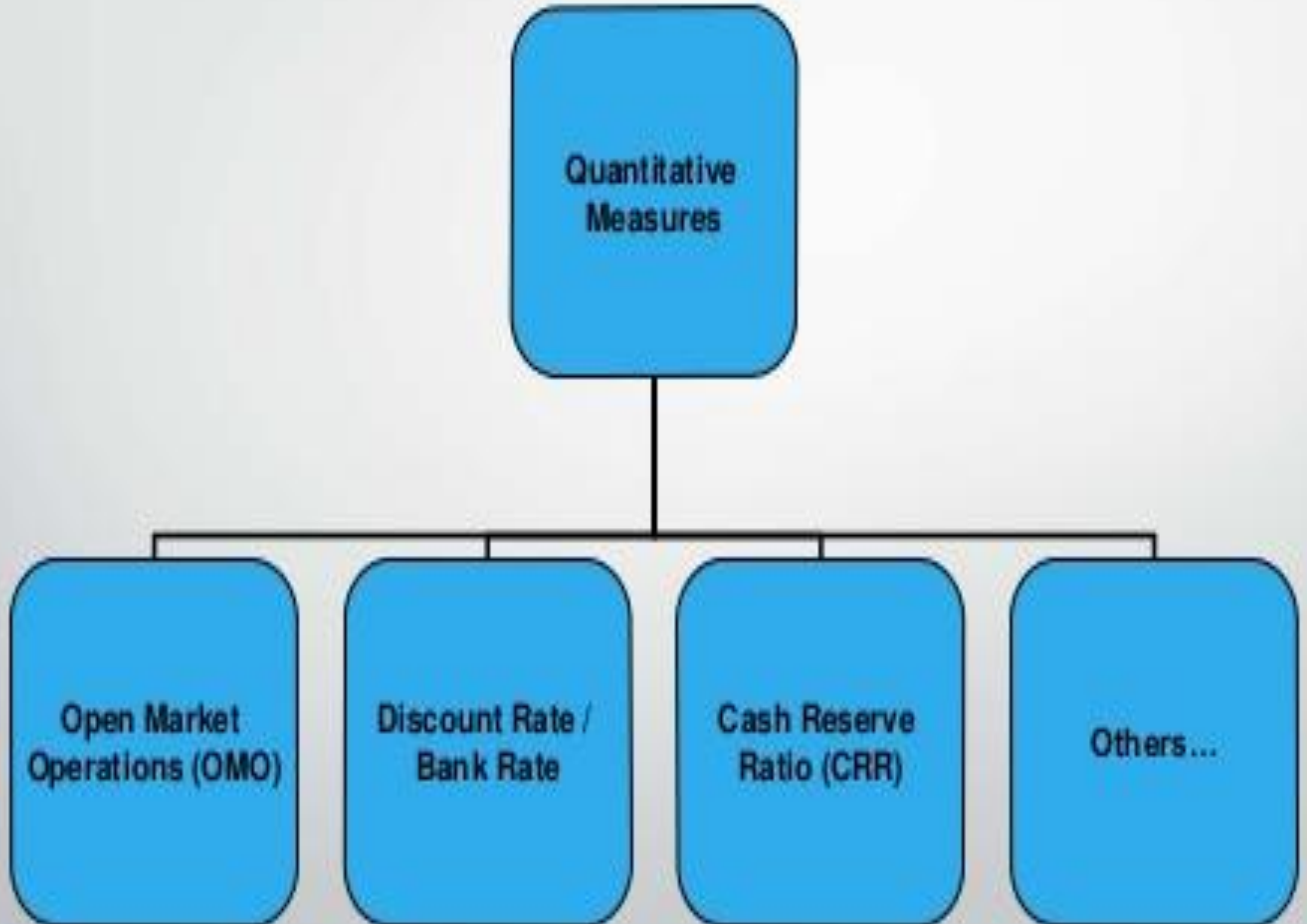
Objectives of monetary policy:

- Maximum feasible output.
- High rate of growth.
- Fuller employment.
- Price stability.
- Greater equality in the distribution of income and wealth.
- Healthy balance in balance of payments(BOP).

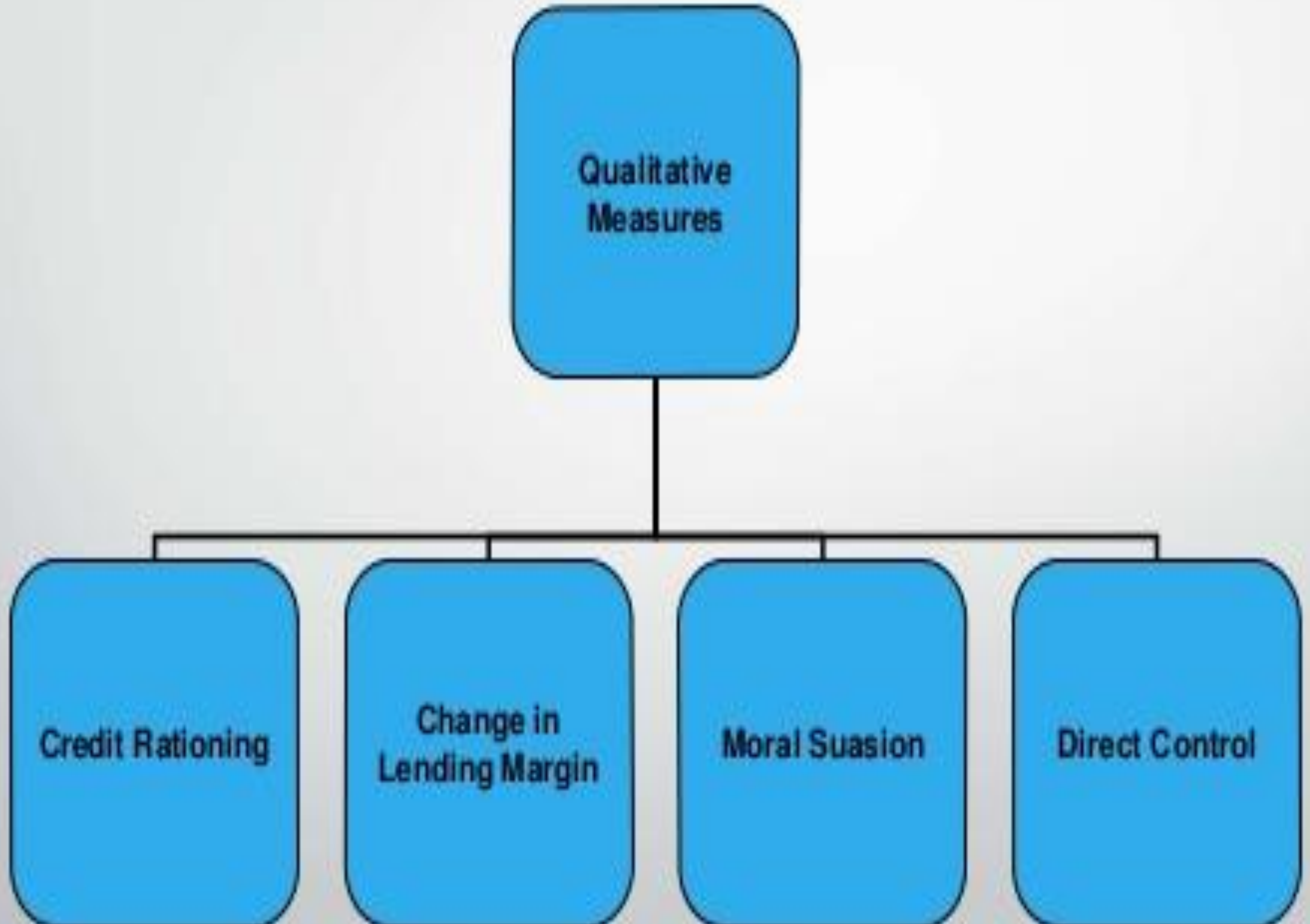
Instruments / Tools Of Monetary Policy



Quantitative Measures



Qualitative Measures



1) Open Market Operations (OMO)

- RBI sells or buys government securities in open market depend upon - it wants to increase the liquidity or reduce it.

- **RBI sells government securities**

  It reduces liquidity (stock of money) in the economy.So overall it reduces the money supply available with banks, Reduces the capital available for lending and interest rate goes up.

- **RBI buys securities**

  Increases the money supply available with banks , so interest rate moves down and business activities like new investments, capacity expansion goes up.

2) Discount Rate / Bank Rate (9%)

Bank rate is the minimum rate at which the central bank provides loans to the commercial banks. It is also called the discount rate.

or

Is the interest rate charged on borrowings (Loans and Advances)

made by the commercial bank from the central bank.

- Central Bank can change this rate – depending upon Expansion or Contraction of credit flow.
- A fall in Bank Rate- Expansionary Monetary Policy
- A rise in Bank Rate – Contractionary Monetary Policy

3) Cash Reserve Ratio (CRR) (4%)

All commercial banks are required to keep a certain amount of its deposits in cash with RBI. This percentage is called the **Cash Reserve Ratio**.

- To prevent shortage of cash
- To control Money supply
- In Contractionary policy the bank raises the CRR
- In Expansionary policy bank reduces the CRR
- A hike in CRR will lead to high interest rate, credit rationing, huge decline in investment and large reduction in National Income and Employment

Other Methods…….

1) <u>Statutory Liquidity Requirement (SLR) (22%)</u>

- Another kind of reserve, in addition to CRR.

- It's the proportion of the total deposits which commercial banks are required to maintain with the central bank in the form of liquid assets

  - Cash reserve, Gold, Government Bonds

- This measure was undertaken to prevent the commercial bank to liquidate their liquid assets when CRR is raised.

2) Reporate (8%)

- Whenever the banks have any shortage of funds they can borrow it from RBI.
- Repo rate is the rate at which our banks borrow rupees from RBI.
- A reduction in the repo rate will help banks to get money at a cheaper rate.
- When the repo rate increases borrowing from RBI becomes more expensive.
- The repo rate transactions are for very short duration
- It denotes injection of liquidity.

3) **Reverse Reporate (7%)**

- A reverse repo rate is the interest rate earned by a bank for lending money to the RBI in exchange for Government securities.
- Reverse repo is an arrangement where RBI sells the securities to the bank for a short term on a specified date.
- RBI us his tool when there is to much liquidity in the banking system.
- Reverse reporate means absorption of liquidity.
- They give money to depositors at 4% and turn around and lend that money to others that want to buy a home or expand their business at 6-8% or higher depending on the risk.If they lend more money than they take in on a given day they may have to borrow money from the fed on a short term basis which would be

1) **Credit Rationing**

- Shortage of funds, priority and weaker industries get starved of necessary funds.
- Central Bank does credit rationing
  - Imposition of upper limits on the credit available to large industries.
  - Charging higher interest rate on bank loans beyond a limit

2) **Change in Lending Margins**

- Bank provides loans upto a certain percentage of value of mortgaged property.
- The gap between the value of the mortgaged property and amount advanced is called as **lending margin.**
- Central Bank has the authority to determine the lending margin with the view to decrease and increase the bank credit
- The objective is to control speculative activity in the stock market.

3) **Moral Suasion**

- It's a Psychological instrument instrument of monetary policy
- Persuading and convincing the commercial bank to advance credit in accordance with directive of the central bank.
- The Central bank uses moral pressure on the commercial bank by going public on the unhealthy banking practices.

4) **Direct Controls**

- Where all the methods become ineffective
- Central bank gives clear directives to banks to carry out their lending activity in a specified manner.

Monetary Policy to Control Recession

Problem: Recession

Measures:

1) Central Banks buy securities through OMO
2) Lowers Bank Rate
3) Reduces CRR

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Money Supply Increases

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Interest Rate Falls

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Investment Increases

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Aggregate Demand Increases

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Aggregate Output increases

Monetary Policy to Control Inflation

Problem: Inflation

Measures:

1) Central Banks sells securities through OMO
2) Increases Bank Rate
3) Raises CRR

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Money Supply Decreases

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Interest Rate Rises

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Investment Declines

↓

Aggregate Demand Declines

↓

Price Level Falls

POLICY RATES AS ON FEBRUARY 2020

- CRR - 4 %
- SLR - 18.25 %
- REPO - 5.15 %
- REVERSE REPO - 4.9%
- BANK RATE - 5.4%

Current Scenario

- RBI, in its final bi-monthly monetary policy meet of FY2019-20 (represents April 2019-March 2020), decided to put a pause on its policy rate cut for the second consecutive time on account of a sharp rise in inflation rate beyond its upper band of 6%.
- Current repo rate is kept unchanged at 5.15% and the current reverse repo rate at 4.90%.
- Retail inflation reached 7.59 % in January 2020. This is because of sharp increase in food inflation(13.63%) in January 2020.
- RBI acknowledges that in the credit market, the full benefit of previous policy rate cuts has not been passed on to consumers yet.

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