International Journal of Engineering Research & Management Technology
ISSN: 2348-4039
Email: editor@ijermt.org July-2014 Volume 1, Issue-4 www.ijermt.org

A STUDY OF RBI'S MONETARY POLICY (WITH REFERENCE TO IT'S OBJECTIVES)

Dr. Kapil Garg
Assistant Professor
Department of Commerce
NAS College, Meerut

ABSTRACT: Reserve Bank of India was nationalized in the year 1949 with the objective to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. As a central bank, the Reserve Bank has significant powers and duties to perform smooth and speedy progress of the Indian Financial System. Among others it includes maintaining monetary and financial stability, to develop and maintain stable payment system, to promote and develop financial infrastructure and to regulate or control the financial institutions.

Monetary policy is concerned with the measures taken to regulate the supply of money, the cost and availability of credit in the economy. In developed countries the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy. The Monetary Policy of RBI is not merely one of credit restriction, but it has also the duty to see that legitimate credit requirements are met and at the same time credit is not used for unproductive and speculative purposes RBI has various weapons of monetary control and by using them, it hopes to achieve its monetary policy.

In this study, the major factors that determine the effectiveness of monetary policy have been analyzed and to find the general impact of monetary policy on the Indian economy and especially to find out the role of monetary policy in facilitating economic growth, different monetary instruments and steps taken by RBI have also been studied.

KEY WORDS: Reserve Bank of India, Monetary Policy, Price Stability

INTRODUCTION

The central bank of the country (Reserve Bank of India) was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2, 20,000. The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank. Reserve Bank of India was nationalized in the year 1949 with the objective to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.

As a central bank, the Reserve Bank has significant powers and duties to perform smooth and speedy progress of the Indian Financial System. Among others it includes maintaining monetary and financial stability, to develop and maintain stable payment system, to promote and develop financial infrastructure and to regulate or control the financial institutions. To quote C. Rangarajan, a former Governor of Reserve Bank of India. "Faced with multiple objectives that are equally relevant and desirable, there is always the problem of assigning to each instrument the most appropriate target or objective. Of the various objectives, price stability is perhaps the one that can be pursued most effectively by monetary policy. In a developing country like ours, acceleration of investment activity in the context of supply shocks in the agricultural sector tends to be accompanied by pressures on prices and, therefore, monetary policy has much to contribute in the short-run management."

MONETARY POLICY OF RBI

Monetary policy is concerned with the measures taken to regulate the supply of money, the cost and availability of credit in the economy. Further, it also deals with the distribution of credit between uses and users and also with both the lending and borrowing rates of interest of the banks. In developed countries the monetary policy has been used for overcoming depression and inflation as an anti-cyclical policy. However, in developing countries it has to play a significant role in promoting economic growth. The Monetary Policy of RBI is not merely one of credit restriction, but it has also the duty to see that legitimate credit requirements are met and at the same time credit is not used for unproductive and speculative purposes RBI has various weapons of monetary control and by using them, it hopes to achieve its monetary policy.

THE MONETARY POLICY PROCESS

The Reserve Bank's Monetary Policy Department (MPD) assists the Governor in formulating the monetary policy. Views of key stakeholders in the economy, advice of the Technical Advisory Committee (TAC), and analytical work of the Reserve Bank contribute to the process for arriving at the decision on policy repo rate. 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 will determine the policy interest rate required to achieve the inflation target. The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day-to-day liquidity management operations. The Financial Markets Committee (FMC) meets daily to review the consistency between policy rate, money market rates, and liquidity conditions.

OBJECTIVES OF MONETARY POLICY

1-Price Stability- Achieving price stability has remained the dominant objective of monetary policy of Reserve Bank of India. It may however be noted that price stability does not mean absolutely no change in price at all. In a developing economy like ours where structural changes take place during the process of economic growth some changes in relative prices do occur that generally put upward pressure on prices. Therefore, some changes in price level or, in other words, a certain rate of inflation is inevitable in a developing economy. Thus, price stability means reasonable rate of inflation. A high degree of inflation has adverse effects on the economy. An expert committee on monetary reforms headed by Late Prof. S. Chakravarty suggested 4 per cent rate of inflation as a reasonable rate of inflation and recommended that monetary policy by RBI should be so formulated that ensures that rate of inflation does not exceed 4 per cent per annum. Emphasizing the importance of price stability from the viewpoint of India's balance of payments, Prof. Rangarajan writes, "The increasing openness of the economy, the need to service external debt and the necessity to improve the share of our exports in a highly competitive external environment require that the domestic price level not be allowed to rise unduly, particularly since our major trading partners have had notable success in recent years in achieving price stability.

*2- **Economic Growth-*** Promoting economic growth is another important objective of the monetary policy. Monetary policy can promote economic growth through ensuring adequate availability of credit and lower cost of credit. However, during the seventies, eighties and the first half of nineties, Reserve Bank followed a tight monetary policy under which Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) were continually raised to restrict the availability of credit for private sector. Besides, lending rates of interest were kept at high levels which discouraged private investment. This tight monetary policy worked against promoting growth. To ensure higher economic growth the adequate expansion of money supply and greater availability of credit at a lower rate of interest is needed.

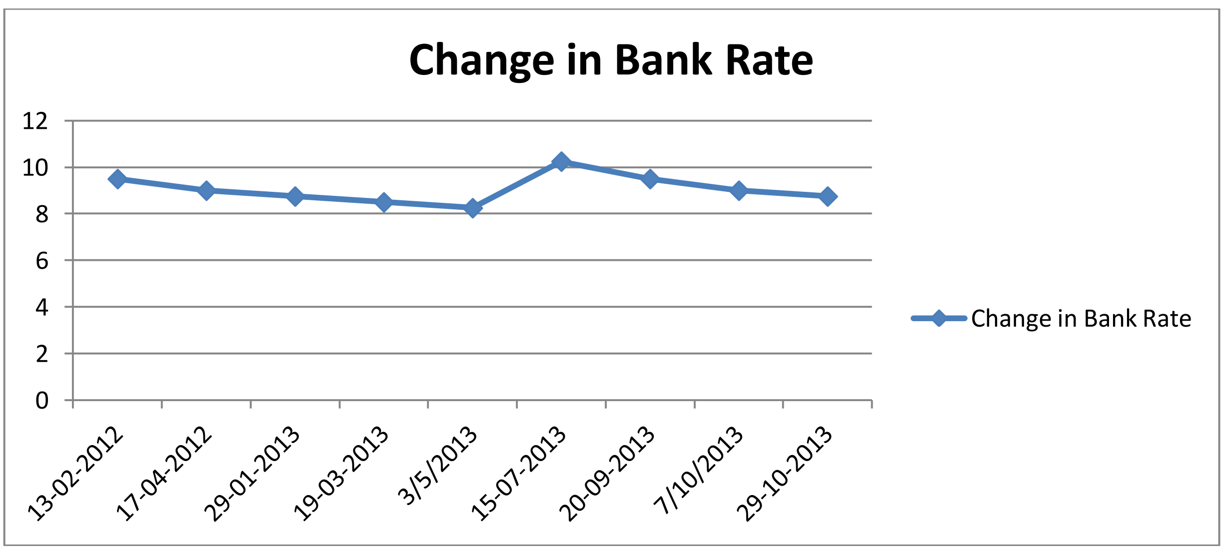
3- Exchange Rate Stability- The policies of floating exchange rate and increasing openness and globalization of the Indian economy, adopted since 1991 have made the exchange rate of rupee quite volatile. Through rise in the cost of credit and reduction in the availability of credit, borrowing from the banks were discouraged which was expected to reduce the demand for dollars. The higher interest rates in India would also discourage foreign institutional investors and Indian corporate to invest abroad. This will also work to reduce the demand for dollars which will prevent the fall in the value of the rupee. Alternatively, to prevent the depreciation of the rupee; Reserve Bank can release more dollars from its foreign exchange reserves. The release of more dollars by Reserve Bank will increase the supply of US dollars in the foreign exchange market and will therefore tend to correct the mismatch between demand for and supply of the US dollars. This will help in stabilizing the exchange rate of the rupee. In the context of flexible exchange rate system, Reserve Bank has to intervene frequently to achieve stability of exchange rate at a reasonable level.

INSTRUMENTS OF MONETARY POLICY

A) -General/Quantitative Instruments

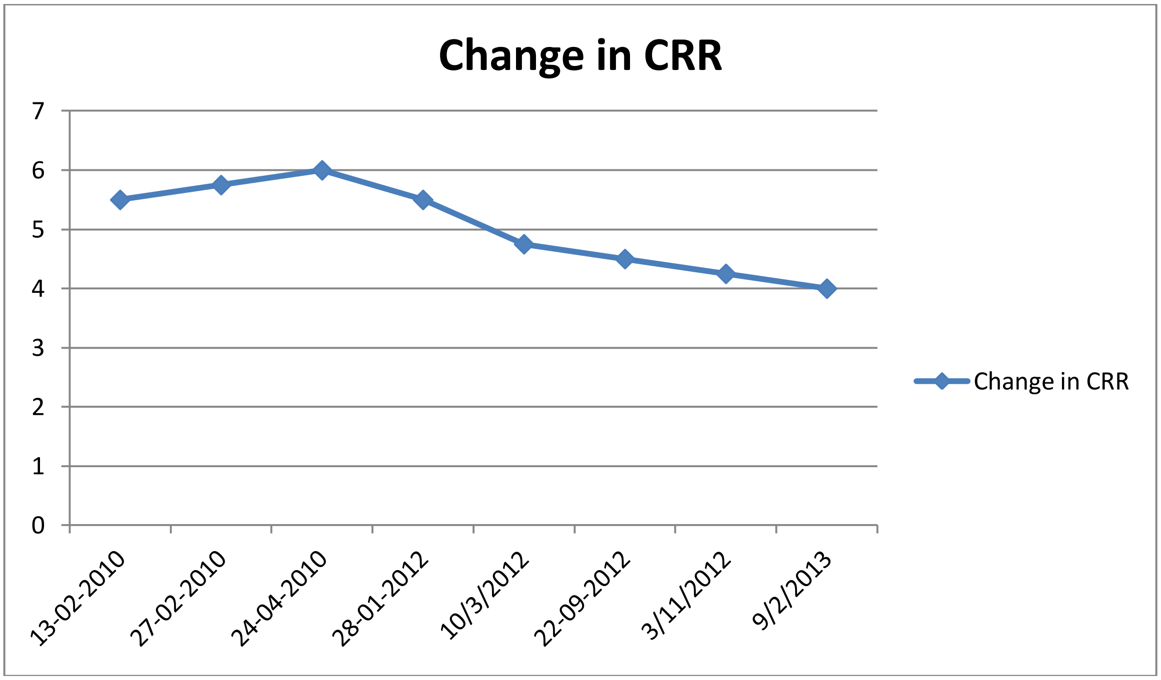
1. *Bank Rate Policy:-*Bank rate is the rate at which the Central bank lends money to the commercial banks for their liquidity requirements. Bank rate is also called discount rate. In other words bank rate is the rate at which the central bank rediscounts eligible papers (like approved securities, bills of exchange, commercial papers etc) held by commercial banks. Bank rate is important because it is the pace setter to other market rates of interest. Bank rates have been changed several times by RBI to control inflation and recession.

Effective Date	13-02-2012	17-04-2012	29-01-2013	19-03-2013	03-05-2013	15-07-2013	20-09-2013	07-10-2013	29-10-2013
Bank Rate	9.50	9.00	8.75	8.50	8.25	10.25	9.50	9.00	8.75



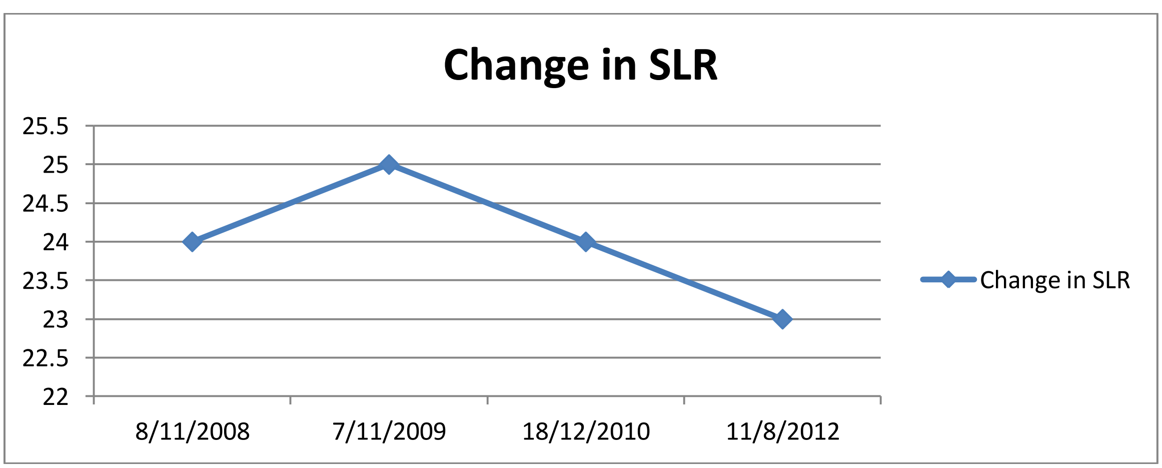
2. *Cash Reserve Ratio (CRR)-*The Gash Reserve Ratio (CRR) is an effective instrument of credit control. Under the RBl Act of, l934 every commercial bank has to keep certain minimum cash reserves with RBI. The RBI is empowered to vary the CRR between 3% and 15%. A high CRR reduces the cash for lending and a low CRR increases the cash for lending. The CRR has been brought down from 15% in 1991 to 5.5 % in Feb. 2010. It further reduced to 4.5% in Sep. 2012. As of March 2013, CRR is 4%.

Effective Date	13-02-2010	27-02-2010	24-04-2010	28-01-2012	10-03-2012	22-09-2012	03-11-2012	09-02-2013
CRR	5.50	5.75	6.00	5.50	4.75	4.50	4.25	4.00



3. ***Statutory Liquidity Ratio (SLR)***-Under SLR, the government has imposed an obligation on the banks to maintain a certain ratio to its total deposits with RBI in the form of liquid assets like cash, gold and other securities. Between 1990 and 1992 SLR was as high as 38.5%. Narasimham Committee was not in favour to maintained of high SLR. The SLR was lowered down to 25% from 10thOctober 1997.It was further reduced to 24% on November 2008.Country has seen the decreasing trend as it was 22% in 2014.

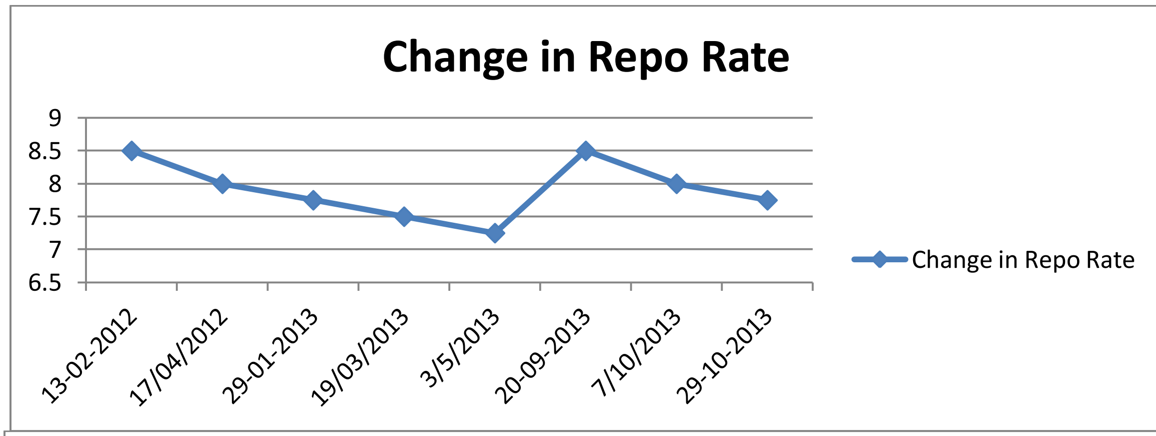
Effective Date	08-11-2008	07-11-2009	18-12-2010	11-08-2012
SLR	24.00	25.00	24.00	23.00

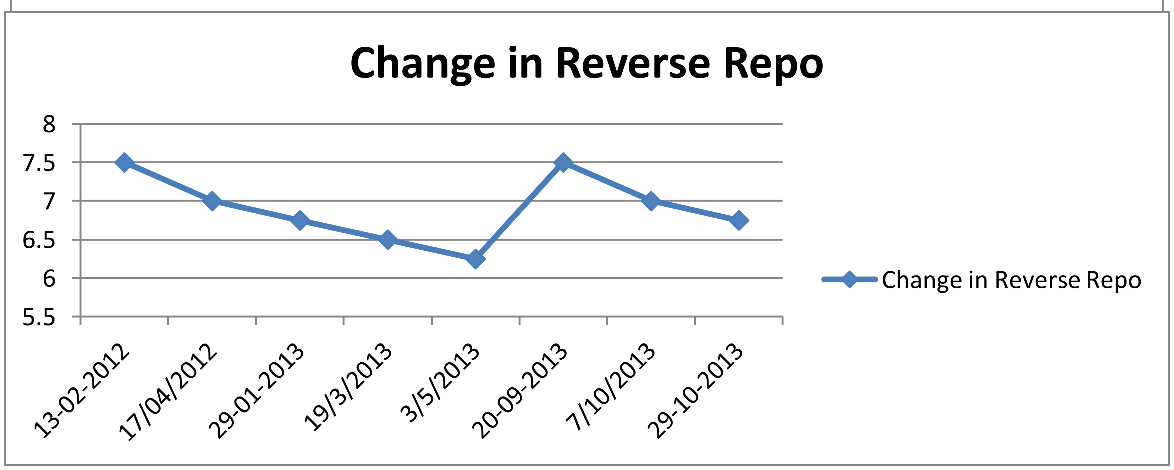


4. ***Repo and Reverse Repo Rates-***In determining interest rate trends, the repo and reverse repo rates are becoming important. Repo means Sale and Repurchase Agreement. Repo is a swap deal involving the immediate Sale of Securities and simultaneous purchase of those securities at a future date, at a predetermined price. Repo rate helps commercial banks to acquire funds from RBI by selling securities and also agreeing to repurchase at a later date.

Reverse repo rate is the rate that banks get from RBI for parking their short term excess funds with RBI. Repo and reverse repo operations are used by RBI in its Liquidity Adjustment Facility. RBI contracts credit by increasing the repo and reverse repo rates and by decreasing them to expand credit. Repo rate was 8.00% in April 2012 and Reverse repo rate was 7.00% for the same period. In Jan 2014, again they were at same level i.e. 8.00% and 7.00%.

Effective Date	13-02-2012	17-04-2012	29-01-2013	19-03-2013	03-05-2013	20-09-2013	07-10-2013	29-10-2013
Repo Rate	8.50	8.00	7.75	7.50	7.25	8.50	8.00	7.75
Reverse Repo	7.50	7.00	6.75	6.50	6.25	7.50	7.00	6.75





5. ***Open Market Operations:-***It refers to buying and selling of government securities in open market in order to expand or contract the amount of money in the banking system. This technique is superior to bank rate policy. Purchases inject money into the banking system while sale of securities do the opposite. During last two decades the RBI has been undertaking switch operations. These involve the purchase of one loan against the sale of another or, vice-versa. This policy aims at preventing unrestricted increase in liquidity.

B)-Selective / Qualitative Instruments

Under Selective Credit Control, credit is provided to selected borrowers for selected purpose, depending upon the use to which the control tries to regulate the quality of credit - the direction towards the credit flows. The Selective Controls are:-

1. ***Ceiling on Credit***- the Ceiling on level of credit restricts the lending capacity of a bank to grant advances against certain controlled securities.

2. ***Margin Requirements***- A loan is sanctioned against Collateral Security. Margin means that proportion of the value of security against which loan is not given. Margin against a particular security is reduced or increased in order to encourage or to discourage the flow of credit to a particular sector. It varies from 20% to 80%. For agricultural commodities it is as high as 75%. Higher the margin lesser will be the loan sanctioned.

3. ***Discriminatory Interest Rate (DIR)***- Through DIR, RBI makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. RBI issues supplementary instructions regarding granting of additional credit against sensitive commodities, issue of guarantees, making advances etc.

4. ***Directives:-***The RBI issues directives to banks regarding advances. Directives are regarding the purpose for which loans may or may not be given.

5. ***Direct Action***-It is too severe and is therefore rarely followed. It may involve refusal by RBI to rediscount bills or cancellation of license, if the bank has failed to comply with the directives of RBI.

6. ***Moral Suasion***-Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with authorities of commercial banks in this respect.

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

CONCLUSION

RBI adopted multiple indicator Approach in which it looks at a variety of economic indicators and monitor their impact on inflation and economic growth. 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. With globalization 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.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.

However RBI has made serious efforts to implement monetary policy, some problems are still exist like Central Government's huge budgetary deficits have made monetary policy ineffective. In India, inflation also results from deficit financing and scarcity of goods on which RBI may not have any control. Presence of unorganized sector of money market is one of the main obstacles in effective working of the monetary policy. 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 in this way overall economy is affected. Thus, from the study, it is clear that despite several problems RBI has made a good effort for effective implementation of the monetary policy in India.

REFERENCES

1. Ananya Mukherjee Reed: Corporate Governance Reforms in India in Journal of Business Ethics, Volume 37, Number 3 / May, 2002, p. 253.
2. Bernanke, B. and Mishkin, F. (1997), “Inflation Targeting: A New Framework for Monetary Policy?”, The Journal of Economic Perspectives, Vol. 11, No. 2, pp. 97-116
3. Broadbent, B. (2013), “Is Inflation Targeting Dead?”, in Reichlin, L. and Baldwin, R., “Is Inflation Targeting Dead?”, CEPR, London
4. Kumar, A. and Boopathy, G. M. (2013), “National Price Indices and Inflation during 2012”, Central Statistical Organization
5. Mohanty, D. (2010), “Measures of Inflation in India: Issues and Perspectives”, IARNIW Conference Speech, Thiruvananthapuram
6. Mukherjee, S. and Bhattacharya, R. (2011), “Inflation Targeting and Monetary Policy Transmission Mechanisms in Emerging Market Economies”, IMF Working Paper, WP/11/229
7. Rajan, R. (2013), “Statement on taking office on September 4, 2013”, Reserve Bank of India
8. Reserve Bank of India Act, 1934 (As modified up to 27 February 2009)". Reserve Bank of India (RBI). Retrieved 20 November 2010
9. Reserve Bank of India (2013), “RBI sets up Expert Committee to revise and strengthen Monetary Policy Framework”, Press release, RBI Mumbai